RETAINAGE, H.R. 5022

HEARING

BEFORE THE

SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE AND GENERAL SMALL BUSINESS PROBLEMS

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

WASHINGTON, D.C., MAY 5, 1982

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
95-280 O WASHINGTON : 1982

H721-29

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CONTENTS

Page

Hearing held on May 5, 1982 1

Opening statements of:

- McDade, Hon. Joseph M., a Representative in Congress from the State of Pennsylvania 36
- Mitchell, Hon. Parren J., chairman, Subcommittee on SBA and SBIC Authority, Minority Enterprise and General Small Business Problems ... 1

Panels consisting of:

- Gallagher, Mark A.; Thomas P. Furey; Alfred C. Harrell; and William Richie 45
- Knott, Martin G.; Robert L. Wilkinson; John Bachand; and Dennis Lavallee 7

Testimony of:

- Bachand, John E., president, McAuliffe & Sons, Inc., Plymouth Meeting, Pa., and vice president, Door & Hardware Institute 19
- Callas, Michael, president, Callas Contractors, Inc., Hagerstown, Md 3
- Furey, Thomas P., president, Furey Heating and Air Conditioning, and member, Sheet Metal and Air Conditioning Contractors' National Association, Inc 51
- Gallagher, Mark A., president, Standard Mechanical Contractor, Inc., on behalf of the National Association of Plumbing-Heating-Cooling Contractors 45
- Harrell, Alfred C., president, Hi Lo Industries, Inc., and member, National Association of Minority Contractors; accompanied by Dewey Thomas, executive director 65
- Knott, Martin G., president, Martin G. Knott, Inc., Baltimore, Md., and member, board of directors, American Subcontractors Association 7
- Lavallee, Dennis, member, executive committee, Small Business Legislative Council, and director of government affairs, National Association of Plumbing-Heating-Cooling Contractors 28
- Richie, William, president, Richie Electric Co., San Antonio, Tex 67
- Stone, Robert A., Deputy Assistant Secretary of Defense Facilities, Environment, and Economic Adjustment, Department of Defense; accompanied by Col. Robert Glogal, Assistant Director of Construction 40
- Wilkinson, Robert L., president, Associated Specialty Contractors, Inc. 11

Additional material supplied for the hearing record:

- Bachand, John E., president, McAuliffe & Sons, Inc., Plymouth Meeting, Pa., and vice president, Door & Hardware Institute: Prepared statement and attachments 22
- Callas, Michael, president, Callas Contractors, Inc., Hagerstown, Md.: Exhibit to testimony 5
- Furey, Thomas P., president, Furey Heating and Air Conditioning, and member, Sheet Metal and Air Conditioning Contractors' National Association, Inc.: Prepared statement and attachments 55
- Gallagher, Mark A., president, Standard Mechanical Contractor, Inc., on behalf of the National Association of Plumbing-Heating-Cooling Contractors: Prepared statement and attachments 48
- Harrell, Alfred C., president, Hi Lo Industries, Inc., and member, National Association of Minority Contractors: Survey referred to in testimony. 66
- Lavallee, Dennis, member, executive committee, Small Business Legislative Council, and director of government affairs, National Association of Plumbing-Heating-Cooling Contractors: Attachments to testimony 32
- Stone, Robert A., Deputy Assistant Secretary of Defense Facilities, Environment, and Economic Adjustment, Department of Defense: Prepared statement 40
- Wilkinson, Robert L., president, Associated Specialty Contractors, Inc.: Prepared statement 14

FEDERAL RETAINAGE POLICY

WEDNESDAY, MAY 5, 1982

House of Representatives, Subcommittee on SBA and SBIC Authority, Minority Enterprise and General Small Business Problems, Committee on Small Business,

Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN MITCHELL

Mr. Mitchell. Good morning. The hearing will now come to order. Today, we begin an inquiry into the efficacy of the Federal Government's traditional practice of retaining a portion of moneys owed to private contractors performing Government contractual work. Specifically, it is our intent to discern whether or not the practice of retainage on Government jobs significantly impedes the progress of small businesses in this country.

Retainage is the practice, as you well know, of holding back a percentage, usually 10 percent, of progress payments made to contractors during the course of performance of their work on Federal Government projects. The concept of retainage has been employed in the past as an incentive for satisfactory completion of all work to be done on the contract. Furthermore, retained funds theoretically constitute a type of trust fund to be used in the event a contractor defaults in the performance of his work.

However, in today's climate, the practice of retainage appears to be redundant and counterproductive. The Government now has at its disposal other more effective methods of assuring timely and proper performance by the contractor. The performance bonding requirement, both at the general and subcontracting level, and the authority of Government contracting officers are more viable methods of assuring prompt and satisfactory completion of work on a project.

Witnesses today will testify as to the detrimental effects of this outmoded practice. Among other things, retainage drives up the cost of construction to the Government, creates significant cash flow problems for the contractor, mandates additional borrowing by private firms and, finally, delays the completion of the project in certain instances.

I want to make it very, very clear, this committee does not have jurisdiction over this piece of legislation. Jurisdiction is vested in the hands of the Government Operations Committee. However, we are working very closely with that committee, and the purpose of the hearing this morning is to assure that we have all the ammunition we need in working in a close supportive fashion with the Government Operations Committee.

At a time when Federal deficits are reaching crisis proportions, the elimination of retainage could reduce the cost of the Federal Government's contractual work by almost 4 percent. Needless to say, I and many of my colleagues are most concerned with finding any additional revenues which can be more appropriately dedicated to other Government programs designed to meet directly the needs of our citizens.

It seems to me that at a time when real interest rates are prohibitively high, inhibiting business expansion and job growth, retainage forces small contractors to reach into scarce capital markets in order to borrow the money needed to cover cash-flow problems which might not otherwise arise if the Government's retainage policy could be eliminated.

Most recent estimates indicate that small contractors are forced to carry an average of $370,000 of retainage on their books at any given time. That is a lot of money. Obviously, by having this money available to them, small businesses could have their bonding capacity increased and be able to undertake additional work and provide jobs for those most in need of them, the semiskilled and the unskilled. It is certainly not necessary to dwell on the present dismal unemployment statistics and the severity of impact of the lack of the job opportunities for America's young adults, especially those in minority groups

I think many of us in the Congress, and certainly I am one, are committed to finding solutions to these problems and I am pleased to have introduced this legislation, H.R. 5022, which can have the effect of providing additional jobs by eliminating the Government's policy of retainage. If there is any chance at all that the new jobs can be provided, that businesses will grow, that the Federal deficit can be reduced by the passage of this legislation, then I believe that that effort has to be made.

Today, we shall hear from individuals employed both as general contractors and subcontractors. We shall also hear from the Federal Government with respect to the practice of agencies in the area of retention. In connection with this legislative effort, we are pleased to see that the Department of Defense, an agency with perhaps the largest volume of contracting work to be done, seemingly, has apparently eliminated its practice of withholding funds owed to contractors. This significant step clearly indicates that retainage on Federal work is not at all necessary to accomplish critical Government contracts.

I want to welcome all of the witnesses here and make my usual statement whenever I have a hearing. I am embarrassed. People in business can't afford the luxury of being away from their business for a day. If I am away from my office for a day, I get very nervous. If you are away from your business for a few hours, you get very nervous and I know that many of you come at great sacrifice. We are most grateful that you do take the time to come and be with us.

Our first witness today is Mr. Michael Callas, president of Callas Contractors, Inc., a native Marylander from Hagerstown who just had a meeting last night involving some very significant people.

Mr. Callas, would you come to the witness stand, please?

TESTIMONY OF MICHAEL CALLAS, PRESIDENT, CALLAS CONTRACTORS, INC., HAGERSTOWN, MD.

Mr. CALLAS. Good morning, Mr. Chairman. I appreciate your comments with regard to businessmen taking time off from their work to come to Washington to testify at congressional hearings because after I give my testimony I have an inspection up in western West Virginia and I appreciate the staff putting me on first. I am going up there to try to collect some retainage of about $25,000 that I have been waiting for since October.

Mr. Chairman, I am Michael Callas, president of Callas Contractors, a general building construction firm located in Hagerstown, Md. I am also a member representing the Associated Builders & Contractors, commonly referred to as ABC, a national construction trade association with nearly 17,000 member firms, employing over 1 million construction workers throughout the United States.

Members of ABC believe in what we call the merit shop philosophy, a concept which calls for open competitive bidding, with contract awards to the lowest responsible bidder. Today, more than 60 percent of construction in the United States is done the merit shop way. Furthermore, I am happy to report that ABC supports your bill, H.R. 5022, the Small Business Contract Payment Procedures Act, which states that Federal contracting officers cannot withhold retainage from progress payments if the work done is satisfactory or if the firm is a small business firm, which has posted a performance bond. I thank the committee for the opportunity to testify on the subject of retainage and its impact on the small business construction companies and related industries of our country.

A company performing a contract for an agency of the Federal Government will bill the Government, usually at the end of each month, for the value of the work it has completed during the preceding month. The Federal Government policy is to withhold a certain percentage of the amount of money due the contractor, for work that the contractor has already performed. This amount of money withheld is commonly referred to as retainage, that is held back or retained by the Federal Government, supposedly to insure satisfactory completion of all the required contractual work. At least, this was the purpose of the retainage policy when it was devised some years ago.

Today, retaining a portion of the contractor's payments to insure adequate performance is duplicative of other standard procedures that are now employed in our industry. For years now, contractors and subcontractors have been required to furnish Government agency performance bonds issued by reputable surety companies, guaranteeing satisfactory completion of their contractual work. So today, retainage is an unneeded double protection which places a very severe burden on contractors and subcontractors, yet affords no extra assurance to the Government's interests.

Mr. Chairman, the impact of retainage on small business construction firms is really staggering today, and it is actually counterproductive. First of all, the policy of withholding a portion of the requisitioned funds from the contractor each month places a severe restraint on the contractor's operations by reducing his cash flow. These moneys that are due the contractor, moneys, which he has already paid out weekly for payroll, materials, supplies, equipment rental, must be quickly replaced in order for him to continue his ongoing, day-to-day operations. These moneys must be made available, usually by borrowing from a financial institution at today's very high interest rates. This practice places such a heavy financial burden on the contractor, that the contractor often must reduce his scope or volume of work, or literally avoid participating in contracts where retainage is required.

This amount of retainage, and it is usually approximately 10 percent, is often greater than the total markup on the project. The retainage is often withheld for considerable periods of time after the contract has been completed.

Construction firms with limited capital, which have retainages outstanding for long periods of time are strapped financially, and therefore unable to meet their financial obligations when due.

My company, which is a small business company, Mr. Chairman, was awarded a $740,000 construction contract from the U.S. Fish and Wildlife Fisheries Academy Training Center at Leetown, W. Va. in July 1979. All contractual work on that particular project was completed and our final requisition for payment was submitted to the proper authorities on January 9, 1981. After many phone calls, letters, and finally assistance from both of our U.S. Senators, we were finally paid the retainage, $37,002, in September 1981, 8½ months after the project was completed and occupied.

Needless to say, Callas Contractors was forced to finance our construction operations by short-term borrowing from a local bank at rates at that time at prime or above, and they were 20 or 21 percent. I would like to comment here on this particular job, which was a successful job for our company, our gross profit on the job was only 6 percent.

My firm was awarded another contract, a $3 million construction project, at the National Fire Academy in Emmitsburg, Md., in May 1980. The students occupied this remodeled classroom building, existing dormitories, in September 1981. As of today, 8 months later, retainage of $79,500 is still unpaid.

I have for the record, Mr. Chairman, and not with my submitted testimony, a list—and I asked my controller yesterday at 4 o'clock if she would prepare a list of the jobs that Callas Contractors has as of yesterday that have retainage due. We have 14 jobs of various sizes and the total retainage being withheld at this time in my small business company is $1,180,000.

Mr. Mitchell. We would like to have that submitted for the record.

Mr. Callas. Yes, sir. Our staff has prepared it for you, Mr. Chairman. [See exhibit A:]

Exhibit A.—*Callas Contractors, Inc., contract retainage, May 4, 1982*

1. AOPA office building	$46,845
2. AOPA graphic arts building	1,550
3. Avemco office building	101,892
4. First National Bank—Germantown	14,131
5. Fort Ritchie, sewage treatment plant	
6. Fort Detrick, isolation room	4,900
7. State use industries food processing plant	25,044
8. National Fire Academy	79,500
9. Leetown spring and reservoir development	19,573
10. Chessie system, lift station	960
11. Contract 1, Hagerstown water pollution control	587,249
12. Washington Garden Apartments	277,254
13. Maryland Department of Environmental Services, sewage treatment plant	16,856
14. 3M	4,230
Total	1,179,984
Shady Grove, Leetown, holding in addition to retainage	68,417

Mr. **Callas**. Mr. Chairman, when the general contractor doesn't get paid, unfortunately the subcontractors don't get paid. Nonpayment of retainage, I can assure you, after some 30 years in this business, is one of the largest, most dastardly causes of disputes on Government construction projects. It is another reason why many contractors will not bid Federal construction projects.

Mr. Chairman, after some 35 years in this tough and extremely competitive business, I strongly urge you and your committee to draft the appropriate legislation which would prohibit all Government agencies from withholding any retainage from any Federal contractors or subcontractors, so that these contractors can better finance their day-to-day construction operations, so that it can provide them with additional financing that is required for improving their productive methods and to help them to really grow in this real tough market today. The ultimate savings will be realized, first of all, by the Federal Government and, second, by you and me the taxpayers when contractors will lower their bid prices in anticipation of not having retainage withheld in their contract.

Thank you very much, Mr. Chairman.

Mr. **Mitchell**. Thank you very much.

I am correct in my assumption that as of now the contractor does not receive any interest on the funds held in retainage.

Mr. **Callas**. No, sir. We have attempted to do that, but the agencies have not seen fit to do that.

I would like to comment on that retainage, Mr. Chairman. I don't know whether the Federal Government does it—I have to assume they do if they are at all fiscally responsible but this retainage, of course, we are addressing ourself to Federal agencies today—I have been trying to get this retainage eliminated for some 10 or 15 years in my involvement nationally—it would spill over into the private sector because there are some agencies in the private sector that also follow the retainage practice, mainly because the Government does.

We know for a fact companies that we do work for who have withheld our retainage and have placed those funds in their own escrow account in financial institutions reaping off 15 and 16 and 17 percent interest while the contractor is out borrowing money.

Mr. MITCHELL. Yes; you have approximately 14 contracts on that page.

Mr. CALLAS. Yes, sir. I have 14 listed on that page.

Mr. MITCHELL. Do those involve subcontractors as well?

Mr. CALLAS. All of them involve subcontractors.

Mr. MITCHELL. Have any of your subcontractors been forced to close down?

Mr. CALLAS. Mr. Chairman, as I mentioned to you previously I am from Hagerstown, Md. We have a 29-percent unemployment rate. Mack Truck and Fairchild Aircraft are our two biggest employers. They can't seem to sell trucks. Mack Truck had 4,500 employees. We have 2,200 unemployed and the A-10 fighter bomber, which is being produced in Hagerstown has been curtailed, some 90 or 100 and we have about 1,100 from Fairchild Aircraft off work. We are having a very difficult time and, of course, the No. 1 people affected are subcontractors because of the limited amount of work.

Mr. MITCHELL. That is my question. Have any of your subcontractors been forced out of business?

Mr. CALLAS. They certainly have, sir.

Mr. MITCHELL. About how many?

Mr. CALLAS. I would say, at least, I can give you the names of 12 of them within the last year.

Mr. MITCHELL. Now, in your opinion are the bonding requirements sufficient to provide for the completion of contracts?

Mr. CALLAS. Sufficient?

Mr. MITCHELL. The bonding requirements.

Mr. CALLAS. Yes, sir, I would say that they certainly are because the performance bond that we are required to post are written for the total contract amount. If we have a $500,000 job, the retainage would be $50,000, but the bond covers you for the full amount of the contract, all labor, and material and performance.

Mr. MITCHELL. One last question. You have $1 million being held.

Mr. CALLAS. Yes, sir.

Mr. MITCHELL. Can you use that money due in any fashion at all to assist in getting another contract? Can you get any use out of that money?

Mr. CALLAS. Mr. Chairman, 5 years ago, yes, if you had a good reputation or a good financial record with your lending institution, which we do have by the way. We have $250,000 due us whenever we get paid, can we increase our line of credit or can you advance this. But, today, in the tight financial market, even the bank that we have been dealing with for 24 years turns a deaf ear; just turns us off. It is their policy and I assume it is their policy and, consequently, we cannot utilize that as an escrow fund.

Mr. MITCHELL. Other members from the minority side will be coming in. Counsel does represent the minority side here. Do you have questions? Thank you, sir.

Mr. CALLAS. Thank you very much for the opportunity, sir.

Mr. MITCHELL. Do me a personal favor, will you?

Mr. CALLAS. Certainly.

Mr. MITCHELL. After you finish today with that outfit, just give my office a call, and let me know if you have gotten your money.

Mr. CALLAS. That is the best word I have heard. Thank you very, very much.

Mr. MITCHELL. If I am not there, just leave word, yes or no; I got it or I didn't. We thank you very much, Mr. Callas.

Mr. CALLAS. We need Congressmen like you, sir, because this is the problem we are having right up in Leetown right now, getting somebody to put some pressure on these guys. The office is in Denver, Mr. Chairman. We have called on this. We have two projects for them. We call for our payment checks. It is in the computer. That takes usually about 3 or 4 days to get a reply because there is 3 hours difference in Denver. By the time we get a reply then it is lost in the computer. We have waited 4, 5 and 6 weeks over the 30-day period to try to get our payment, besides the retainage that we have been waiting 8 months for.

Mr. MITCHELL. Thank you very much. I would be curious on this one.

Mr. CALLAS. I appreciate your offer to help us.

Mr. MITCHELL. Thank you.

We will take these next witnesses as a panel; Mr. Martin P. Knott with the American Subcontractors Association, Mr. Robert L. Wilkinson, president of the Associated Specialty Contractors, Inc., Mr. John Bachand, vice president, Door and Hardware Institute and Mr. Dennis Lavallee of the Small Business Legislative Council.

Gentlemen, thank you very much for being here. I think we have copies of all of your statements. You may pursue either of two options. You can present your statement in its entirety, if you care to, or you can excerpt from the statement and just hit the highlights. I assure you your entire statement will appear in the record of this hearing.

Mr. Knott, why don't we lead off with you?

PANEL CONSISTING OF MARTIN G. KNOTT; ROBERT L. WILKINSON; JOHN BACHAND; AND DENNIS LAVALLEE

TESTIMONY OF MARTIN G. KNOTT, PRESIDENT, MARTIN G. KNOTT, INC., BALTIMORE, MD., AND MEMBER, BOARD OF DIRECTORS, AMERICAN SUBCONTRACTORS ASSOCIATION

Mr. KNOTT. Good morning, Mr. Chairman.

My name is Martin Knott. I am president of Martin G. Knott, Inc., a plumbing contracting firm, Baltimore Md. I am a member of the board of directors of the American Subcontractors Association.

Mr. MITCHELL. Will you pull your mike just a little closer?

Mr. KNOTT. The association represents 4,500 members in virtually every State. It is a true representation of subcontractors in that we are only subcontractors. We have material suppliers and we represent every imaginable trade.

Today, I am testifying on behalf of ASA in support of H.R. 5022, that would permit Federal agencies to reduce or eliminate retainage on Federal construction projects. The Small Business Contract Payment Procedures Act does not require the appropriation of a single penny from the U.S. Treasury. It would not lead to deteriorating contracting performance on Federal projects; yet, it would give the beleaguered construction industry the kind of boost it so desperately needs.

Retainage is the practice of holding back a stated percentage, usually 10 percent, from each progress payment to be paid upon completion of the contractor's work or completion of the entire project. Thus, as the contractor completes 100 percent of each segment of the contract, he receives only 90 percent of the agreed price. The retained moneys may be held for months, or even years, even though the contractor's work has been completed and accepted by the construction owner and the people have moved in.

Historically, retainage was withheld from contract payments for several reasons: To provide leverage against the contractor to insure that the contract is fully performed; to provide partial financial security for the owner if work was not completed in accordance with the contract; to discourage financially irresponsible contractors from attempting to perform the work; and to save the owner the cost of interest on the amounts retained.

These reasons are no longer valid today.

The construction industry is the only business in the United States that adheres to 10-percent retainage. The use of the outmoded retainage system is particularly prevalent among public agencies at all levels of Government. While many private companies have reduced retainage well below the 10 percent or have eliminated it entirely, most Government agencies have continued to use this system.

Fortunately, there is today a growing awareness among both Government agencies and builders of the need for modernizing this practice with an eye to reducing this unnecessary cost.

In recent years, there has been increasing concern in Government agencies over the failure of contractors to meet the completion dates for new Federal buildings. Because of rapidly increasing costs, such construction delays often force agencies to return to Congress for additional construction funds when projects are not kept within their budget limitations.

However, the argument that retainage is a club for the Government to wield in order to get the building completed on time is illusory. In fact, retainage frequently has just the opposite effect. Industry surveys confirm that by holding retainage until all punchlist items are completed by the general contractor and all subcontractors, an individual contractor or subcontractor is simply not motivated to perform his punchlist when he knows that punchlist work not completed by other trades are going to delay him.

The reduction or elimination of retainage would not increase the Government risk on construction projects since the Miller Act requires a Government prime contractor to provide a performance bond in such amount as the contracting officer deems appropriate. This figure is usually 100 percent of the contract amount. These bonds provide the Government with a guarantee of full performance and payment and full financial security. They also weed out financially unstable contractors. The use of both retainage and bonds results in a double indemnity insurance policy that is very costly to the Federal Government.

Inflation, high-interest rates, budget deficits, whatever the reason, cost is the performance criteria that is currently of greatest concern to the Government. Many think of retainage as a free loan to the Government, but because of the indirect cost being so exceedingly high, this type of financing is far more expensive.

Retainage has forced many capable contractors to increase bids to the Government in order to keep going until retainages are paid. Contractors do not have sufficient capital or borrowing power to cover a large amount of retainage. Nor is it good business for contractors to tie up indefinitely their working capital or borrowing power in retainage. Contractors, of necessity then, must recoup a portion of their negative cash flow created by retainage by increasing their prices to the Government. They also increase the withdrawals in the beginning of the job to try and offset that retainage.

It would seem that the Government could decrease the cost of construction by eliminating or reducing retainage. Early finishing contractors such as grading, foundation, steel erectors, and roofing subcontractors have a 10-percent retainage holdback until the entire general contract is completed and these early finishing subcontractors must normally wait for their retainage from 1 to 2 years. The early finishing subcontractors simply cannot wait that long to collect the 10 percent because they must pay their labor and material currently, and must operate their businesses with normal overhead and profit currently.

Therefore, they calculate their sale price by adding for overhead and profit, which will be paid currently out of the 90-percent progress payments and substantially discount the retainage that they will not receive for 1 to 2 years when a general contractor finishes the entire project.

Elimination of retainage would increase the cash flow of contractors enabling them to procure needed materials at an earlier date and at a lower cost. It would also relieve them of a portion of their interest burdens. These savings would filter back to the Government through lower bids on future projects. In fact, in a survey conducted by ASA, 76 percent of the contractors questioned said they would reduce their prices 3 to 4 percent if retainage was eliminated.

It is obvious then that short-term savings to the Government in interim construction financing on retainage are often more than offset by additional permanent financing costs for the entire project which includes amounts added by contractors and subcontractors to their prices to cover the cost of carrying retainage over an extended period. Elimination or reduction of retainage would give potential bidders a means of reducing their bids on projects at no cost to the Government. As a matter of fact, it would save the Government money.

The practice of withholding retainage from progress payments creates a serious negative cash flow for the contractor which becomes more and more burdensome as work progresses. Contractors must pay their weekly labor costs and their material monthly or more frequently to obtain the vendor discounts. Contractors must also cover their indirect costs currently. It is grossly unfair to put this financial burden on subcontractors.

Contractors must cover retainage by either borrowing the money from financial sources to replace the retainage or funding the retainage out of working capital. If a contractor borrows the money, he must pay interest at today's inflated rates. If retainage is funded out of working capital, the result is a complete withdrawal of working capital because when each contract is performed and retainage paid on that contract, another contract will normally take its place with a similar or greater amount of retainage.

Thus, retainage is not only contrary to the general principle that payment is due when performance has been completed, it promotes increased costs, credit problems, bankruptcies and an entire realm of other negative factors. It is no wonder that so many contractors have come to realize that retainage amounts due them have become a major reason for their financial problems.

Elimination of retainage on Government construction projects would release about $3 billion to over 100,000 construction contractors. Can you imagine the number of jobs that would be created and the increased productive ability of these firms if they had access to these funds?

Retainage has deterred many capable contractors from bidding on Government jobs where retainage is required. They are simply reluctant to get involved in projects where they know they'll have to borrow money to pay bills because Government holds up money they have already earned. The result is reduced bid competition for Government construction contracts and an increase in construction costs to the Government.

Contractors and subcontractors are primarily interested in getting paid for work satisfactorily performed. When a contractor receives a progress payment less a percentage for retainage, he is getting less than full value for the work he has performed and he begins to wonder whether one party to a contract is capitalizing on the use of money earned by another. An adversarial relationship thus often develops between the subcontractors and the prime contractor and between the prime contractor and the Government. This psychological effect works against a cooperative effort on the project. It the Government agency is using high retainage as a means of leverage against the prime contractor, who passes along retainage to his subcontractors, this psychological effect may more than offset the benefits of such financial leverage.

When the Government withholds retainage, it has no means to escape the problems created. When contractor's costs go up, the Government will pay, directly or indirectly. The Government receives higher bids on its projects, in some cases substantially over estimate. On projects already under contract, where little can be done by the Government to alleviate unanticipated contractor expense, the cost to the Government may take the form of delay. A contractor who has lost most of his profit expectation in a job but who still has a lot of work to complete, poses another kind of problem to the Government. A contractor cannot be expected to work for nothing and the Government gets no "bargain" when a contractor is precluded from earning a reasonable profit.

Retainage, which involves billions of dollars, thus creates a vicious circle in which the Government, general contractors, subcontractors, and their employees all lose in the long run.

ASA strongly supports H.R. 5022, the "Small Business Contract Payment Procedures Act," which would largely eliminate retainage on Federal Government construction projects. Elimination of retainage would lower Government costs and accelerate cash flow into the economy. It would help the construction industry by infusing it with capital. And it would help construction workers who are the ultimate losers when a contractor goes bankrupt.

We are working on a project that we finished last October. We have been off the job since October and we are waiting for $80,000 in retainage to be paid. It is an FHA project done by private development company and all the subcontractors have finished. The project delays and waiting for them to go to cost certification and waiting for them to get through the massive amounts of problems have delayed the project and we estimate that we will get it approximately 10 months after the job was finished. There are many jobs like that and there are many contractors that are having these problems. It is like you getting your check and them holding 10 percent, saying that if you do a good job in a year we will give you the rest of it. That is the problem that is happening, and it is putting a tremendous burden on everyone.

We wholeheartedly support your efforts to eliminate this. Thank you very much.

Mr. **Mitchell.** Thank you.

What I think we would like to do is to hear from all of the witnesses and then put questions to all four of you if that is satisfactory.

So, we will hear from Mr. Wilkinson next.

TESTIMONY OF ROBERT L. WILKINSON, PRESIDENT, ASSOCIATED SPECIALTY CONTRACTORS, INC.

Mr. **Wilkinson.** Thank you, Mr. Chairman.

My name is Robert L. Wilkinson. I am president of the Associated Specialty Contractors, or ASC, which is an umbrella organization of eight major national associations of specialty and subcontractors. The segments of the industry that we represent have approximately 165,000 business establishments, over 98 percent of which would be classified as small business, with annual sales of about $63 billion and 1,300,000 employees.

We support very strongly the concept of H.R. 5022 and the elimination of retainage on Federal projects. We are in favor, however, of an amendment to this legislation, which would require pass-through to subcontractors of the benefits to prime contractors of any changes in the retainage rate. I will explain that a little further.

I am going to summarize some of the things in my written statement; the written statement will contain more details.

We feel that the original justifications for retainage, as you stated, Mr. Chairman, in your opening remarks, are now completely invalid because the Government does have better methods of assuring timely and proper performance and also of securing payment for subcontractors and suppliers, which are the two reasons supposedly that retainage was instituted in the first place.

It is clearly unreasonable to withhold a portion, usually 10 percent, of the progress payments which have been earned by the contractor or the subcontractor for which he has already paid the expenses for a period of 2 or 3 years in order to assure contractor completion of the final punchlist work, which is the largest source of the complaints that performance is not completed; the punchlist work are the relatively minor corrections and repairing of the damages caused during the period of construction, and completion of a few items revealed by the final inspection.

Most of the work has been performed on construction jobs and is performed on construction jobs by subcontractors. The subcontractors are well aware of the fact, as the previous witnesses have said, that they individually are not going to be paid their retained funds and their final payment until all of the other subcontractors have completed their work, as well as the prime contractor. So, there is no incentive to go ahead and finish the punchlist work. The incentive is to be as late as possible in the hope that will be the final trip to the jobsite and the final work to be done. It is not an incentive to complete this work. It is actually a disincentive.

Many well-managed and competent firms are seriously hurt, as you have heard by requirements for retainage, and I would like to set forth scenarios, if you will, of what could happen.

In the first one and, unfortunately, not an uncommon one, the low bidder has failed to allow enough, in his estimate of cost, to pay for the high interest rates required during this 2- or 3-year period that his money is tied up to borrow working capital to keep the project and his other work going. This omission in the estimate is very likely the reason he was the low bidder.

As a result of this failure, he is forced to continue in a negative cash flow position for so long that he is no longer able to borrow funds at any interest rate and, thus, is unable to pay his labor and suppliers. He defaults and another contractor must be employed to complete the work at much higher cost.

By this time the low bidder has been forced into default by retainage, and has no assets to pay the additional cost for completion. So, if he is a prime contractor, the Government is going to pay the additional cost. If he is a subcontractor and his default results in the default of the general contractor, again, the Government will pay the cost of completion.

The very purpose of retainage then has been frustrated by the retainage itself, namely assurances that performance will be satisfactory and the creditors will be paid.

Now, scenario B would be that the bidders have allowed in their cost estimate for the cost of financing, the retainage, with enough contingency factors included to take care of delays of several months of the type you have heard about from previous witnesses after completion before receipt of the retained funds, and also to take care of higher interest rates.

The result of this is going to be much higher cost to the Government, much higher cost for construction, since all of the bidders obviously have included the allowance for this increased cost. The Government can certainly borrow money at a significantly lower rate than contractors can for short-term working capital loans.

We need to look at the nature of the construction industry to fully understand this problem. All contractors must pay wages weekly, obviously retaining nothing from the earnings of employees, which would be unlawful. Suppliers must be paid monthly. It is quite unusual to withhold retainage on payments due suppliers for materials which have been delivered. Suppliers are treated differently in this respect from subcontractors in almost all cases.

Almost all overhead costs either must be paid weekly or monthly in the form of wages and salaries. Contractors operate on very small profit margins, 2 to 4 percent generally speaking. So, in most cases, the amounts retained exceed the contractor's profit, which he obviously needs to buy additional tools and equipment and to pay stockholders for the use of their capital. Thus, for many months the contractor is paying out more money in the cost of what he has installed for the benefit of the Government than he has received in return in payment. The deficiency must be made up by borrowing at interest rates ranging from 18 to 22 percent, usually well above the prime rate.

Most of the contractors doing Federal work are subcontractors, as I said, 90 to 95 percent of whom qualify as small business firms under the Small Business Administration $5 million size standard. Contractors of this size generally are not able to borrow money at the prime rate for relatively short-term loans with no security other than the retained funds to be released at some unknown and distant time after the prime contractor has received his own retainages from the Government.

In my written testimony I presented a hypothetical cash flow illustration for a typical subcontract of $240,000 for a project lasting 18 months.

Mr. MITCHELL. What page is that?

Mr. WILKINSON. Page 11, sir. It starts actually at the bottom of page 10.

A retainage rate of 10 percent has been used and the assumption has been made that the contractor had to borrow working capital to replace retained funds at an interest rate of 18½ percent. It might be of interest to note that at an 18½ interest rate, by the time you pay interest on the interest, it comes to 22 percent. Retained funds at the end of the project would, of course, amount to $24,000, but the interest paid by the contractor to the bank to replace the money that was tied up for 23 months would equal over $23,000 or more than the contractor's profit for his investment of capital.

Now, the example given there includes not only retainage, it also includes the effect of another deferred payment which is not an issue here today. That is the fact that some Government agencies will not reimburse the contractor for materials purchased in advance to be sure they are available and stored on site. Both of those factors are in the calculations. However, retainage is a very substantial part of that calculation.

Now, the interest payments in this case would equal more than 8 percent of the contract price; 105 percent of the amount the subcontractor allowed in his bid for his profit. Obviously, if he were to break even he would have had to figure a larger amount for profit and overhead than he did to cover the cost of the interest.

It is of the utmost importance that Congress also recognize the interests of the Government in the performance, competitiveness, and survival of subcontractors regardless of considerations of privity of contract. Government agencies, Federal agencies, in particular, have long been of the opinion that they have no obligation to consider the needs of subcontractors because they have no privity of contract. This matter of this legal theory, I believe, has already been disposed of by Congress in other matters of legislation, such as those pertaining to equal employment opportunity, affirmative action, Buy America, minority business enterprises, in which the contracts with general contractors and the Government require that certain terms be included in subcontracts. By the same token, this is a type of exemption from privity of contract; we believe the same thing can be done to make sure that if retainage is eliminated for general contractors, that it will also be eliminated for subcontractors.

If any special provisions or rates are made for general contractors, they must be required to reflect these same rates and considerations with their subcontractors. There are some State laws that have provisions of that type. If we do not have provisions of that type, then the effort will be generally futile because of the large percentage of the work that is performed by subcontractors.

We would have to say that it can be expected that without requirements of this type general contractors would impose some type of retainage provisions in excess of those imposed on them. The general contractor would be receiving "interest-free" loans from his subcontractors for the duration of the project because he would pass along their requisitions for progress payments in full, together with his markups, receive payment from the Government for the entire amount and then retain and invest for his own enrichment a portion of each subcontractor's payment. That enrichment is considerable at present money market rates. After substantial completion, the general contractor could then benefit from a lengthy delay of final completion if the subcontract provided that he is to pay the subcontractor upon receipt of payment.

Mr. Chairman, I appreciate the time of the committee to unburden myself of what has been a matter of concern to me for 32 years.

Thank you.

[Mr. Wilkinson's prepared statement follows:]

PREPARED STATEMENT OF ROBERT L. WILKINSON, PRESIDENT, ASSOCIATED SPECIALTY CONTRACTORS, INC.

Mr. Chairman, my name is Robert L. Wilkinson, and I am appearing today as President of the Associated Specialty Contractors, Inc. (ASC). ASC is an "umbrella" organization of eight national associations[1] of construction specialty employer contractors. The segments of the construction industry represented by ASC affiliates consist of about 165,000 business establishments with annual sales of about $63 billion and 1,300,000 employees. The large majority of these firms, probably 98 percent, are small business enterprises.

I am appearing today to express the strong support of the Associated Specialty Contractors for H.R. 5022 which would eliminate retainage from contractors' progress payments on most construction contracts of executive agencies. We thank Mr. Mitchell for introducing this bill. However, we do strongly urge the addition of language incorporating an explicit and enforceable provision requiring the benefits of the legislation to flow through to subcontractors.

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[1] Mason Contractors Association of America, Mechanical Contractors Association of America, Inc., National Association of Plumbing, Heating, Cooling Contractors, National Electrical Contractors Association, National Insulation Contractors Association, National Roofing Contractors Association, Painting & Decorating Contractors of America, and Sheet Metal & Air Conditioning Contractors National Association, Inc.

The practice of retaining a percentage of progress payments may have had some justification at one time. However, in today's business climate and practice it has outlived its usefulness and is proving to be a deterrent to vigorous competition in the construction industry by small business firms and to cause unnecessary costs to government.

There were two basic reasons for establishing the practice of retaining a percentage of progress payments due construction contractors and subcontractors for work already performed.

1. The unpaid balance of amounts due the contractor or subcontractor was used as an incentive for his satisfactory completion of all work on the contract. Non-payment of the retained funds was omnipresent as a penalty to be enforced in case of non-performance.
2. Retained funds constituted a kind of trust fund which could be used to pay subcontractors, suppliers and job site employees of the contractor in the event of his default. This insulated the owner from legal actions against the property being improved. The funds could also be used by the owner to pay another contractor to complete the work on which the first contractor had defaulted.

Two other reasons have sometimes motivated private owners to require retainages, although these reasons should never have been a factor in Governmental procurement:

3. The owner can hold and invest the contractor's funds to his own benefit during the period of construction.
4. Retainage tends to eliminate from bidding competition any underfinanced contractors, since the severe cash flow problems generated by the practice of retention make it difficult for any firm to compete, regardless of its competency to perform the work, unless it is well capitalized and has good borrowing capacity. As a matter of fact, 20 to 30 years ago, when working capital could be borrowed at four or five percent interest, it was not unusual for better established and larger contractors to argue in favor of maintaining fairly high retainage rates as a deterrent to "excessive" competition.

None of the original justifications remain valid today, with existing bonding and performance provisions. The government has two other more effective methods of assuring timely and proper performance. Performance bonds and the authority of a contracting officer to terminate contractors for default because of their failure to perform in accordance with the contract and to charge the contractor the full amount paid by the government for having others complete the contract are potent tools to assure prompt completion. Labor and material payment bonds assure the payments of subcontractors, suppliers and workers. Government, by law, is exempted from liens filed by such creditors, so the need does not exist to maintain funds to pay creditors. Furthermore, subcontractors, suppliers and labor have been foreclosed from making legal demands on funds retained from contractors on Federal construction because there is no privity of contract between the creditors and the government.

It is patently unreasonable to withhold portions of progress payments for work which has been satisfactorily performed over a period of two or three years in order to assure contractor completion of the last few corrections and omissions. Following substantial completion the Government might withhold a sufficient amount from the last progress payment to cover the reasonable cost of making small, final, so-called "punchlist" corrections. It is universal practice for the representative of a construction owner to make a detailed final inspection of construction work upon substantial completion and to list each remaining deviation from the plans and specifications, omissions, needed corrections of defective work or materials, or damages to installations incurred during the construction process. This list is the "punchlist". Its use does not preclude holding the contractor liable for additional corrections during the warranty period, normally up to one year after final completion.

There is no question about the contractual and moral responsibility of each contractor to perform punchlist work. It is expensive and aggravating work, however, since most, if not all, of the contractor's employees have left the job site and gone on to other projects. Skilled workers, knowledgeable about the plans and specifications and how the project was built, must be taken from other jobs and brought back with necessary tools and equipment to perform the punchlist work. Although contractors recognize their responsibilities to do this work, those who have had unsatisfactory relations with contracting officers or inspectors and who expect additional nitpicking corrections following completion of what should be a final punchlist may delay performance of the punchlist work in the hope that final payment will indeed be made shortly after such completion and that all corrective work can be completed at one time.

Even more important is the fact that most of the work actually has been performed by subcontractors who have learned, usually from bitter experience, that they are unlikely to receive final payment and release of retainage until all the other work of all the other contractors on the job has been completed and the prime contractor has received final payment for the entire project. Subcontractors can wait six months to a year or even much longer after completion of their work, including all punchlist work, before they receive final payment. Having no incentive to complete their work any earlier than the work of others has been completed, subcontractors sometimes are inclined to postpone punchlist work until a more convenient time. It is important, both to achieve satisfactory performance and to be fair and consistent, that legislation eliminating retainage on prime contractors also provide that no funds be retained by prime contractors from subcontractors except in circumstances parallel to those justifying retainage by the Government from payments to prime contractors under this Act. Implementing regulations should require that subcontractors, in turn, assure the flow-through of such provisions to sub-subcontractors. Regulations should also assure that any amounts retained from the final payment to cover the cost of punchlist work be released to the prime contractor and, subsequently, by him to each subcontractor upon the completion of that subcontractor's punchlist.

Retainage on Federal projects seldom if ever accomplishes the original objective of assuring payment of subcontractors suppliers and labor. Rulings of the Court of Claims and the Comptroller General prevent such creditors from bringing action against the Government to prevent release of the retained funds to the prime contractor until all of his obligations have been fulfilled or to secure payment for the creditors from the retained funds. Such legal action is foredoomed because there is no privity of contract between subcontractors and the Government. (Comp. Gen. Dec. D-174534) (10 Dec. 1971); (Comp. Gen. Dec. B-205165 (8 Jan. 1982).

The payment bond required of prime contractors by the Miller Act provides a much more satisfactory recourse for creditors. Prime contractors have every right to require that subcontractors post performance and payment bonds as well, in order to protect the prime contractor, the sub-subcontractors, suppliers and the laborers of the subcontractors.

The use of retainage requirements to "pre-qualify" contractors by making it impossible for those who are underfinanced to participate in Governmental construction for this reason not only is an ill-advised method of judging the competency of contractors but will not work. Again, bonding requirements are more satisfactory since sureties must satisfy themselves of the competency and financial capacity of those for whom they write bonds. Many well-managed and competent firms are seriously hurt by requirements for retainage when they must borrow working capital at today's high rates to replace the funds they have earned but have not received. Two scenarios can be visualized:

Scenario A: The low bidder failed to allow enough in his cost estimate to pay the high interest rates required to borrow working capital to keep the project and his other work going during the unknown period of time that his retainage may be tied up. This omission in the estimate very likely could be the reason he was low bidder. As a result of this failure, he is forced to continue in a negative cash flow position so long that he no longer is able to borrow funds at any interest rate and thus is unable to pay his labor and suppliers. He defaults and other contractors must be employed at much higher cost to do the work. By this time the low bidder, who has been forced into default by retainage, has no assets to pay the additional costs for completion, which in most cases far exceed the amount retained. The very purpose of retainage thus has been frustrated by the retainage itself—namely, assurances that performance will be satisfactory and that creditors will be paid.

Scenario B: The bidders have allowed in their cost estimates for the cost of financing the retainage with enough contingency factors included to take care of delays of several months after completion before receipt of the retained funds and also to take care of higher interest rates. The result is much higher construction costs, since allowances have been included in all the bids for borrowing funds for working capital.

The Government can certainly borrow money at a significantly lower rate than contractors can for short-term working capital loans. Private owners who use retained funds to help finance the work are paying so much more for the construction than they are gaining from the "interest-free loans from contractors" that it is not an economic practice. Since the Government can borrow at lower rates than private construction purchasers, it becomes even more uneconomic for the Government to follow such a practice.

The nature of the construction industry should be examined to consider the cash flow problems caused by retainage. All contractors must pay wages weekly, obviously retaining nothing from the earnings of employees, which would be unlawful. Suppliers must be paid monthly. It is highly unusual to withhold retainage on the payments due suppliers for materials which have been delivered. In some cases, progress payments must be made on specially fabricated equipment long before it is delivered. Other materials and equipment often are purchased long before installation to assure that they will be on the job site when needed and, in some cases, to hedge against increasing prices. Although on most private work contractors are now paid for such stored materials, this often is not true on federal work.

Almost all overhead costs either must be paid weekly in the form of wages and salaries or monthly. Contractors operate on very small profit margins, often around two to four percent, so in most cases the amount retained usually exceeds the contractor's profit, which he obviously needs to buy additional tools and equipment and to pay stockholders for the use of their capital.

Thus for many months the contractor is paying out more money in the costs of what he has installed for the benefit of the Government than he has received in return in payment. The deficiency must be made up in some way. Since few contractors have extensive capitalization, it usually must be made up by borrowing at interest rates ranging from 18 to 22 percent, usually well above the prime rate. Most of the contractors doing the work are subcontractors, 90 to 95 percent of whom qualify as small businesses under the Small Business Administration five million dollar size standard. Contractors of this size generally are not able to borrow money at the prime rate for relatively short term loans with no security other than the retained funds to be released at some unknown and distant time after the prime contractor has received his own retainages from the Government.

That most of the costs on construction projects are incurred by subcontractors is indicated by a survey of productivity on hospital construction recently released by the Bureau of Labor Statistics. This indicated that 26.6 percent of the labor cost on hospital construction is incurred by general contractors and 73.4 percent by special trades contractors. An earlier Bureau of Labor Statistics survey of all General Services Administration Federal office building projects completed in 1973 indicated a ratio of 37.6 percent of the labor hours for on-site work performed by employees of general contractors and 62.4 percent by employees of specialty or subcontractors. In some other types of construction the relative importance of subcontractor employment may be even greater. Although ratios of material purchases are not known, it is probable that those made by subcontractors are even greater compared with general contractor purchases than the ratios of labor utilization.

Special or subcontractors customarily furnish the labor, materials and management services to install all heating, ventilating, airconditioning, plumbing, electrical, mechanical equipment, steamfitting, elevators, boilers, painting, decorating, paperhanging, pipe and duct insulation, roofing, masonry, stone, alarm system, communication systems, tile, terrazzo, marble, and ornamental ironwork. Structural steel erection, plastering, lathing, drywall, glazing and wall and ceiling insulation is also performed by subcontractors. In some cases so is site preparation. excavation, grading, concrete work, carpentry, hauling, crane operation, hoisting and other functions.

The following is a hypothetical cash flow illustration of a fairly small subcontract for $240,000 for a construction period of 18 months. Almost ideal conditions are assumed except for retainage, slow release of final payment (although no slower than is customary), and interest rates. These conditions include: completion on schedule; (2) payments received by the subcontractor in the month following billing; (3) no change orders; (4) costs as estimated; (5) only $1,000 of punchlist costs (included in the estimated costs); (6) punchlist work completed in the month following substantial completion; (7) retainage at 10 percent; (8) one month's delay in receiving the last progress payment while punchlist completion was being inspected; (9) four months' delay after final completion to receive retained funds; and (10) working capital borrowed at 18.5 percent, resulting in a net effective cost of 22 percent after borrowing to pay the interest. Total interest incurred to make up for the inability of the contractor to use the retained funds equals $19,354, which is 8.1 percent of the contract price and 10.5 percent of the prime costs. This is an unconscionably high burden on the contractor and the Government which is completely avoidable by eliminating retainage.

Note, too, that the interest paid the bank loaning the contractor working capital to replace the retained funds exceeds the entire profit estimated by the contractor for his investment of capital for equipment, tools and management expertise to perform the work. This is hardly an equitable allocation of rewards.

HYPOTHETICAL CASH FLOW ILLUSTRATION, 18 MO. $240,000 SUBCONTRACT

	Amount	Percent of total	Percent of cost
Prime costs	$185,000	77.1	100.0
Overhead	36,500	15.2	19.7
Profit	18,500	7.7	10.0
Total contract price	240,000	100.0	129.7

Mos. after award	Incurred costs [1] and prorata profit		Progress billing	Retainage	Payment received		Cumulative incurred less received	Monthly financing charges
	Current	Cumulative			Current	Cumulative		
0	[2] $2,000	$2,000	$0	$0	$0	$0	$2,000	$37
1	5,000	7,000	5,000	500	0	0	7,000	128
2	[3] 12,000	19,000	[4] 7,000	700	4,500	4,500	14,500	265
3	[3] 16,000	35,000	8,000	800	6,300	10,800	24,200	443
4	[3] 18,000	53,000	10,000	1,000	7,200	18,000	35,000	641
5	[3] 18,000	71,000	10,000	1,000	9,000	27,000	44,000	805
6	[3] 21,000	92,000	11,000	1,100	9,000	36,000	56,000	1,025
7	11,000	103,000	11,000	1,100	9,900	45,900	57,000	1,045
8	12,000	115,000	12,000	1,200	9,900	55,800	59,200	1,083
9	12,000	127,000	12,000	1,200	10,800	66,600	60.400	1,105
10	13,000	140,000	13,000	1,300	10,800	77,400	62,600	1,146
11	13,000	153,000	13,000	1,300	11,700	89,100	63,900	1,169
12	13,000	166,000	13,000	1,300	11,700	100,800	65,200	1,193
13	12,000	178,000	[5] 14,000	1,400	11,700	112,500	65,600	1,199
14	11,000	189,000	[5] 16,000	1,600	12,600	125,100	63,900	1,169
15	10,000	199,000	[5] 18,000	1,800	14,400	139,500	59,500	1,088
16	12,000	211,000	[5] 22,000	2,200	16,200	155,700	55,300	1,012
17	15,000	226,000	[5] 25,000	2,500	19,800	175,500	50,500	924
18	13,000	239,000	[5] 20,000	2,000	22,500	198,000	41,000	750
19	1,000	240,000	[6] 44,000	0	0	198,000	42,000	769
20	0	240,000	[6] 24,000	0	18,000	216,000	24,000	439
21	0	240,000	[6] 24,000	0	0	216,000	24,000	439
22	0	240,000	[6] 24,000	0	0	216,000	24,000	439
23	0	240,000	[6] 24,000	0	0	216,000	24,000	439
24	0	240,000	[6] 24,000	0	24,000	240,000	0	0
25	0	240,000	0		240,000			19,354

[1] Excluding finance charges (interest on borrowings for working capital).
[2] Preplanning, engineering, procurement, and mobilization expense.
[3] Including materials and equipment purchased and stored for future installation but not billed.
[4] Including one-half of preplanning expense.
[5] Including previously purchased and stored materials and equipment billed after installation.
[6] Repeated billings for retainage after completion.

It is of the utmost importance that Congress recognize the interests of the Government in the performance, competetiveness, and survival of subcontractors regardless of considerations of privity of contract. There is already ample precedent for this disregard for the old theory of privity in laws and regulations on equal employment opportunity, affirmative action, minority business enterprise involvement, Buy America, and other matters of public policy in which prime contractors are required to insert and enforce particular provisions in subcontract agreement. In the case of retainage, the benefits of eliminations will be realized only if the law prohibits prime contractors from retaining monies from their subcontractors when such funds are not to be withheld from prime contractors.

It is necessary that this be made a matter of law. General contractors are in a position of having much greater bargaining power than subcontractors when subcontractors are being written. The general contractor already has the job; the subcontractors are still trying to obtain their contracts. This is true even of the low bidders whose bids were used by the general contractor or prepare his bid. Only the General Services Administration among Government agencies now requires listing of subcontractors whose bids have been used and prohibits substitution of other subcontractors except for limited and specified reasons. Even GSA regulations provide only for listing of major subcontractors. Thus it can be expected that without requirements to the contrary, general contractors would impose retainage provisons in excess of those imposed upon them. The general contractor would be receiving "interest free loans" from his subcontractor for the duration of the project because he would pass along their requisition for progress payments in full, together with his mark-ups, receive payment from the Government for the entire amount and then retain a portion of each subcontractor's payment.

A classic, but not unique, case involved *Midland Engineering Co. et. al.* v. *John A. Hall Construction Company and U.S Fidelity and Guaranty Co.*, heard by the U.S District Court of the Northern District of Indiana (South Bend Division). In this case the general contractor was retaining more from the subcontractors' payment than was being retained from his payments on a school construction project. Long after their work was completed, seven subcontractors brought suit for final payment of the amounts the contractor had withheld. The subcontracts included a clause which said that the final payment to the subcontractor should be made immediately after payment had been received by the general contractor. The Court found that the general contractor was holding $504,000 of subcontractors' money, but that the owner owed the contractor only $257,564. The delay in final payment involved 75 corrections required in the work performed by the general contractor. The Court noted that "a malefic general contractor might intentionally maintain a dispute with the owner which could cause the owner to refuse to make payment; the general contractor could therefore avail himself for several years of funds to which he has no right." This possibility becomes almost a probability when a general contractor can easily invest such unfairly withheld funds in the money market and receive 15 to 18 percent indefinitely or at least until a subcontractor suit is finally brought to trial.

Mr. MITCHELL. Thank you very much for some excellent testimony.

Just before hearing from our next witness, I wish to acknowledge the presence of students and faculty members who are from the 8th Congressional District of Florida. Is that correct? That is the district of our colleague, Congressman Ireland, who serves on this committee.

We are delighted to have you here. One of the pleasures of being in Congress is to see young people come and watch their Government. We welcome you. I don't know where Mr. Ireland is. He is probably in another committee meeting some place. We are all over the place right now, but we do welcome you and we are just glad to have you drop in on this hearing.

Our next witness is Mr. John Bachand.

TESTIMONY OF JOHN E. BACHAND, PRESIDENT, McAULIFFE & SONS, PLYMOUTH MEETING, PA., AND VICE PRESIDENT, DOOR & HARDWARE INSTITUTE

Mr. BACHAND. Good morning, Mr. Chairman, and other members of the subcommittee. It is a pleasure to be here today and I would like to say that Washington has sort of overwhelmed me. I don't get here very often and the halls and the buildings are magnificent and it is a pleasure to be here.

Mr. Name is John Bachand. I am the president of McAuliffe & Sons, Plymouth Meeting, Pa. We are distributors of commercial architectural doors and frames. We have approximately 20 employees and our net sales are $3 million. Let me say out of that $3 million approximately $1 million of that is in the international market, where we ship material to the port and are paid in full when it is received at the port with no retainage.

I am here today in my capacity, however, as a vice president of the Door & Hardware Institute, better known as DHI. We represent nearly 3,500 members, including 500 distributors such as my firm and 2,000 architectural consultants and certified door consultants, professional specifiers of hardware and door products.

We in DHI appreciate your efforts to bring this problem to the attention of Congress. Retainage is a performance protection system which has long outlived its usefulness and effectiveness. In some cases it never really made much sense. Somehow, it has managed to survive, but not without causing undue and unnecessary problems for the smallest firms in our industry. The heart of the problem from our point of view is the artificial strain retainage places upon our cash flow.

I know this committee understands the daily struggles small business encounters in its efforts to maintain a positive cash flow. Large manufacturers have sophisticated collection systems, which place constant pressure on us to pay for goods on time. Ten or even five percent of the job represents a substantial piece of our cash flow margin.

In our business, we wear three hats: We are wholesale distributors; we are part of the construction industry, and we are small business. The typical firm in our industry has a net sale of around $1.25 to $2 million a year. Because of the nature of our relationship with the construction industry, DHI distributors are probably more labor intensive than the typical distributor in other industries. Our cash flow margin is consumed quickly by payroll, payroll taxes, and associated expenses.

The typical firm runs on a 30- to 33-percent margin, which is net sales less the cost of goods. Fifty-six percent of that margin goes to compensation. Compensation costs and the compensation of one employee consumes 3.3 percent of our margin. The firm's share of social security for all employees accounts for 4.1 percent of the gross margin; income tax, 4.5 percent, and if we are lucky, we might take out 7 percent of the margin as retained earnings or profit, which is less than 3 percent of the sales.

At any given time, 5 percent of our gross margin, or 2 percent of net sales, is tied up in retainage. Compare this to other expenses which I just noted associated with doing business and you can see the difficult choices we are faced with. It is obvious that one way or another a distributor must cover for retainage. He will pay his estimated income tax, meet his existing payroll and pay his social security tax. Most likely, he will first try to front end retainage by raising his bid. He would have to raise all of his prices 2.3 percent to cover retainage cost. To make contract sales pay for themselves, he is probably adding 4 percent to the sales. If he can't cover that way and competition usually doesn't permit such a luxury, he is either borrowing the money, postponing hiring of personnel, skipping renovations or purchase of new equipment, which under normal circumstances would come out of retained earnings.

As you can see from this, we are talking about a significant share of operating capital. Our company—I checked just before I left—with receivables of approximately $486,000, retainage represents approximately 12 percent of that total receivable, a significant amount of money for our firm. In our modest corner of the industry, the elimination of retainage could mean 700 to 800 new jobs or could save us nearly $3 million in borrowing cost.

When you expand that reasoning into the entire material supply and subcontracting community, the figures are substantial. The aspect of the figures that I have cited that frightens me the most is the disproportionate cost of retainage. Because there is room for some diversification in our industry and because retainage is not always required, the 5 percent of our total gross margin, or 2 percent of net sales tied up in retainage, is generated by only 36 percent of our net sales.

It doesn't take long to realize that the other divisions of a hardware distributorship are subsidizing the retainage work. For a small firm starting out by specializing in contract sales and most likely cutting his margin thin just to get the work, retainage may represent up to one-third of his margin. Such obstacles significantly lower the odds of survival.

Viewing retainage on a job-by-job basis, the most difficult problem is the length and unpredictability of delays. Our survey of members indicated that most distributors will wait 180 days or more from the date of delivery of goods to release of retainage. A year's delay is not uncommon and almost every distributor can tell you about the 5-year delay and, remember, we are only material suppliers in most cases.

Retainage is an involuntary extension of interest-free credit. It strikes a double blow because it not only creates a cash flow shortage, it also provides cheap operating funds for others. Interest-bearing escrow accounts compensate the distributor for the latter, but do not alleviate his cash flow problems.

To be frank, as material suppliers we have a difficult time understanding the application of retainage to the delivery of goods. The quality of labor is not a major factor in determining our performance. The delivery of goods is tangible, measureable, and final. The Uniform Commercial Code and State contract laws, which represent the normal protection in nearly any other circumstances involving the delivery of goods, do provide the right of inspection and other protections. Performance is complete. For subcontractors retainage overlaps the protection provided by performance bonds. In addition, another factor we must look at is, many firms refuse to bid work with retainage because they cannot afford to tie up working capital.

It is difficult for me to understand why a performance bond is required and retainage is also required to insure completion. This, to me, seems to indicate a double insurance policy.

In conclusion, I would like to thank this committee again for holding these hearings. We are the first to admit that retainage is often a misunderstood problem. Before we can intelligently develop solutions, we must more fully understand the nature of the problem and the alternatives.

I hope my testimony has been of some help and the Door and Hardware Institute is prepared to do whatever we can to assist the committee. Thank you very much.

Mr. MITCHELL. Thank you very much.

[Mr. Bachand's prepared statement with attachments follows:]

PREPARED STATEMENT OF JOHN E. BACHAND, PRESIDENT, MCAULIFFE & SONS, INC., PLYMOUTH MEETING, PA., AND VICE PRESIDENT, DOOR & HARDWARE INSTITUTE

Mr. Chairman, it is a pleasure and an honor to appear before this committee in support of H.R. 5022, the Small Business Contract Payment Procedures Act. My name is John Bachand, and I'm appearing here today in two capacities.

First and foremost, I am a small businessman. I am president of McAuliffe and Sons of Plymouth Meeting, Pa. We are distributors of commercial architectural hardware, doors and door frames. We have 20 employees and our net sales are in the $3 million category.

I also have the privilege of serving as the vice-president of the Door and Hardware Institute and it is primarily in this capacity that I am appearing here today. DHI is the association of 500 distributors such as our firm and some 2,000 architectural hardware consultants who are specifiers of the products we handle. We are pleased that this committee has decided to investigate the problem we know in the business as retainage. The retainage system is an onerous, burdensome practice which has long outlived its effectiveness as a performance safeguard and now serves only as a financial tool for some and a crushing cash flow obstacle for the small firms of the construction industry. We, at DHI, have undertaken a serious study of the impact of retainage on our small corner of the construction industry and I'd like to present the results of our efforts.

Retainage is a system of uncertain origins, uncertain definition and uncertain application. For the purpose of this report, retainage is the amount held back from payments due a contractor until an owner/developer approves the work under contract. Further, although retainage is imposed in a variety of long-term contract situations, our study is confined to the retainage system as it applies to commercial construction.

It is difficult to pinpoint the origin of retainage but certain observations can be made about the practice. It predates several significant developments in construction law and practice, most notably the adoption of the Uniform Commercial Code, and the development of sophisticated performance or surety-bond requirements. There is also speculation that it was developed in an era when general contractors hired laborers to perform functions that are now handled in a more professional manner by independent subcontractors operating their own businesses. Whatever its origins, its purpose was to provide the owner/developer a measure of protection against inadequate or improper performance by a contractor, while recognizing the need to tender payment for work completed and payment due.

If there is such a thing as "normal practice," an owner/developer imposes a retainage withholding upon the general (or prime) contractor. Ten percent of the payment due is the frequent withholding. It is common, though not universal practice, to reduce that percentage after half the project is completed. (The American Institute of Architects recommends language to that effect.) General contractors, at their own business discretion, impose retainage requirements upon subcontractors and material suppliers. The retainage terms may or may not be identical to those requirements imposed upon the contractor by the developer. General contractors submit a voucher for a draw or progress payment according to a set work-completion schedule.

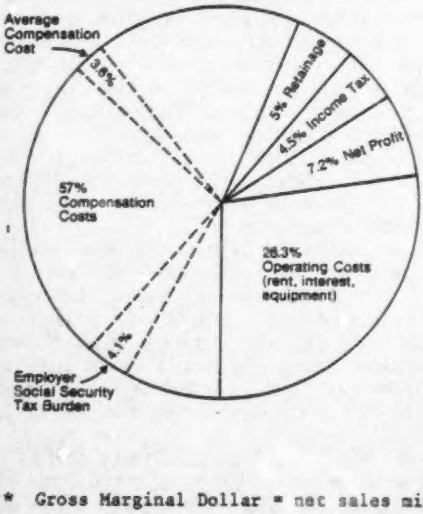
Included in such a draw are costs attributable to work completed by subcontractors or deliveries made by suppliers during that period. The problems of retainage (and the solutions) fall into two general categories: those which reflect the inherent defects in the retainage system and those which result from the use of an outdated system in a changing construction-law environment. Problems which reflect the defects of the system include delays in release resulting from delays in approval, delays while waiting for others to finish work, misapplication of withholding requirements, failure to pass through releases, and establishment of greater withholding percentages.

The Door and Hardware Institute is an international association representing nearly 3,500 companies and individuals in the total-openings industry. Principal among our membership are distributors and specifiers (Architectural Hardware Consultants) of commercial building hardware, doors and door frames. The principal relationship of members to the construction industry is that of material supplier. While many of the problems of retainage affect material suppliers and subcontractors in similar fashion, there are different problems and solutions for each group. The arguments and facts presented herein are directed specifically to the material supplier's situation; we strongly advise that subcontractors' organizations be contacted for full development of additional issues. One last observation: Given the relatively limited involvement of DHI members in the construction process, it should be kept in mind that our estimates of the impact of retainage are likely to be modest compared to the figures of those subcontractors who rely solely on construction.

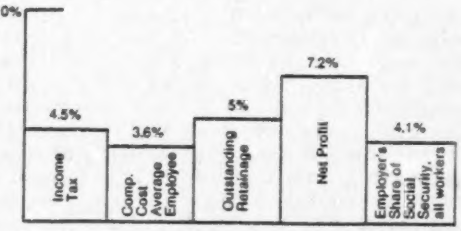
Whatever the abuses and problems of retainage are, the bottom-line effect is the same. Retainage represents a diversion or disruption of cash flow. To weather such a disruption, a small distributor must divert funds from other costs centers such as payroll, taxes or retained earnings. Sometimes the distributor will have to borrow money on a short-term basis to get by. The ironic effect is that the small firm becomes an involuntary banker for others in the construction chain, lending money for months or years at a time. This money is being loaned interest-free despite the fact that, if not for retainage, the money quite properly would be theirs. Though not scientifically devised, a member survey was conducted to determine the effects of retainage on their businesses; this was combined with data regularly collected, so a composite picture could be drawn.

The typical firm in our industry handles net sales of between $1 and 2.5 million annually. The gross margin (net sales minus the cost of goods) is approximately 32 percent. Of the $1–2.5 million in sales, approximately 85 percent of the business involves work (contract-hardware or hollow metal sales) which might be involved in retainage situations. Of that 85 percent only 43 percent actually involves retainage (36 percent of net sales). The gross marginal dollar (GMD), net sales minus the cost of goods, of such a firm is divided among these cost centers: 56 percent is total compensation costs; 3.3 percent is the average cost per employee; 7.2 percent is the net profit after taxes (2.3 percent of net sales); 4.5 percent is for income taxes; and 4.1 percent is for employer's share of all employees' social security taxes. The remainder of GMD is divided among other operating costs (administrative, equipment, debt service, rent, utilities). Because of various retainage-release policies and the diversified nature of our business, outstanding retainage carried by a firm equals 1.9 percent of net sales or 5 percent of GMD. From these figures you can see that retainage represents the value of 1½ jobs (more accurately, two entry-level jobs). It is equal to two-thirds of net profit (primary source of retained earnings) and is more than the amount paid in corporate income taxes. In graphic terms, retainage sizes up as follows:

Door and Hardware Distributor
$1 to 2.5 million sales
Gross Marginal Dollar*



Gross Marginal Dollar Allocations*



* Gross Marginal Dollar = net sales minus the cost of goods

Of course, the more a firm depends on contract sales, the greater the impact retainage has on the firm. Statistical analysis shows that the gross margin of such firms drops by some 3 percentage points. Assuming a firm does 100 percent contract sales and 43 percent of this business requires retainage, then net sales yield a gross margin of 29.5 percent, as noted above. The figures break down as follows: Net profit: 9.1 percent of GMD (2.7 percent of net sales); Income taxes: 4.3 percent of GMD; Average compensation cost of employee: 3.5 percent of GMD; and Retainage: 7.7 percent of GMD.

It becomes obvious that a distributor is faced with several choices: other sales must absorb the losses of retainage, bids must be raised to cover retainage costs, the company must get by with two fewer employees, the owner cannot take anything out of the firm or use retained earnings for expansion, or the owner must borrow to cover retainage.

Several other interesting facts emerged from the survey. The average wait for release of retainage was 143 days and the most frequent response was 180+ days' delay. Many firms replied that a year's delay was not uncommon and at least one firm indicated it carried retainage on the books for five years. One should keep in mind while considering these facts that most of our material suppliers deliver in the second half of the construction schedule. Obviously many subcontractors will experience much longer delays. Some 20 percent of our members refuse to accept projects involving retainage or do not do work involving retainage. As general policy, most distributors indicate they have an official policy of not accepting work requiring retainage, however economic realities force them to accept retainage work. For most, retainage is a difficult problem to assess and cope with.

Retainage can be found in both private- and public-sector construction projects. In procurement matters, civilian agencies are guided by 41 U.S.C. 250 et. seq., and defense agencies follow the law found at 10 U.S.C. 2300 et. seq. Those sections provide the basic framework for government procurement, from solicitation to complete acquisition. Only one section of those laws addresses the subject of payment (41 U.S.C. 255 and 10 U.S.C. 2307). However, neither section provides insight into Congress's view of the need for retainage. The terms of payment therefore are addressed in the two government-wide procurement regulations. For civilian agencies, the Federal Procurement Regulations (FPR) 41 CFR 1-1 et. seq., establish general guidelines on the subject. For defense agencies, Armed Services Procurement Regulations (ASPR) or Defense Acquisition Regulations (DAR) 10 CFR 1-1 et. seq., accomplish the same. (See Appendix A.)

In spite of the general guidelines, policy varies from agency to agency and contracting officer to contracting officer. Some agencies have documentable policy; others have informal policies. (Appendix B.) Although no agency has a retainage policy in excess of 10 percent, reports indicate a range from strict adherence to 10 percent withholding, to zero retainage. Further, federal policy addresses only the relationship between the government and the prime contractor.

Over the years, government procurement policy has been the subject of intensive scrutiny. One such attempt to formulate a consistent, uniform policy was undertaken by the U.S. Commission on Government Procurement which reported its findings in a 35-volume study in 1972. The commission's construction study group made the following recommendation for the government's policy on retainage:

Retained percentages: That FPR and ASP be amended to permit as normal practice the elimination of retainage on progress payments provided the contract is on schedule. That retention be limited to that required to assure completion of remaining work near the end of construction. As an alternate, that the retained funds be paid the contractor when and if he deposits in escrow eligible securities or bank certificates of deposit (Final Report Study Group #13-C Construction, U.S. Commission Government Procurement, 1972, Volume 31). (Text—Appendix C.)

The rationale for the application of retainage to material suppliers is not readily apparent. In its purest form, the purpose of retainage was to provide the owner/developer with some measure of protection against shoddy performance of labor. It was believed to be difficult to measure the adequacy of labor until there was a completed product. Material supply is subject to an entirely different set of laws. Delivery of goods is tangible, complete and measurable. Goods are available for inspection and most state laws and the Uniform Commercial Code provide for the right of inspection. The Code and State laws also provide for a number of remedies for both improper delivery and defective goods.

Subcontractors currently are burdened by the duplicative protection of performance bonds and retainage. Both accomplish the same result. Uneven application of retainage withholdings and the uncertainties of work approval result in delays of release. The net effect is to force smaller firms to act as bankers for others, lending money interest-free for months and years at a time. In the best of times, retainage represents a serious disruption to the cash flow of a firm. In difficult economic times it can precipitate a payroll or tax crisis—or even bankruptcy. The solutions are many and varied. In situations where there is no legal foundation for retainage and other legal remedies are available, or where other protection is available, retainage should not apply. If retainage must be withheld, at a minimum funds should be placed in interest-bearing escrow, and release should be on a "line-item basis" to insure that subcontractors or suppliers are not forced to wait for others to finish work. In some cases direct payment from the owner/developer to the subcontractor/material supplier may be the ultimate solution.

Retainage is an antiquated system of protection which has outlived its effectiveness. Rather than provide protection it has added to the costs of construction and contributed to delays. For material suppliers the logic of the system would not appear to apply. We believe that, first and foremost, the government will save money by eliminating retainage. We estimate that just for our members' portion of the construction contract the existence of retainage may add 3 percent to the bid price for our contract. Although the hardware and door segment is relatively small in comparison to the remainder of the industry, rough estimates indicate at any given time it is carrying $10-17 million in retainage. The costs of borrowing to cover retainage may be as high as $2-3 million a year. Finally, it may be costing as many as 700-800 new entry-level jobs in distributor firms. Quite honestly, we would prefer to see a bill which goes even further than H.R. 5022. As you know, H.R. 5022 does not require that the general contractor pass through the benefits of this bill. We hope they will follow the example of the government in reconsidering the value of the retainage system. However, we do recognize the importance of the type of homework this committee is doing to identify and understand the problems of retainage and to explore and consider all alternatives which may alleviate the burdens imposed by this practice on small distributors. Thank you.

APPENDIX A

PAYMENTS TO CONTRACTOR (1979 MAR) (41 CFR 1-7.602-7)

(a) The government will pay the contract price as hereinafter provided.

(b) The government will make progress payments monthly as the work proceeds, or at more frequent intervals as determined by the Contracting Officer, on estimates approved by the Contracting Officer. If requested by the Contracting Officer, the contractor shall furnish a breakdown of the local contract price showing the amount included therein for each principal category of the work, in such detail as requested to provide a basis for determining progress payments. In the preparation of estimates the Contracting Officer, at his discretion, may authorize material delivered on the site and preparatory work done to be taken into consideration. Material delivered to the Contractor at locations other than the site may also be taken into consideration (1) if such consideration is specifically authorized by the contract and (2) if the Contractor furnishes satisfactory evidence that he has acquired title to such material and that it will be utilized on the work covered by this contract.

(c) In making such progress payments, there shall be retained 10 percent (10%) of the estimated amount until final completion and acceptance of the contract work. However, if the Contracting Officer finds that satisfactory progress was achieved during any period for which a progress payment is to be made, he may authorize such payment to be made in full without retainage of a percentage. Also, whenever the work is substantially complete, the Contracting Officer shall retain an amount he considers adequate for the protection of the Government and, at his discretion, may release to the Contractor all or a portion of any excess amount. Furthermore, on completion and acceptance of each separate building, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made therefore without retention of a percentage.

(d) All material and work covered by progress payments made shall thereupon become the sole property of the Government, but this provision shall not be construed as relieving the Contractor from the sole responsibility for all material and work upon which payments have been made or the restoration of any damaged work, or as waiving the right of the Government to require the fulfillment of all of the terms of the contract.

(e) The Contractor shall, upon request, be reimbursed for the entire amount of premiums paid for performance and payment bonds (including coinsurance and reinsurance agreements, when applicable) after furnishing evidence of full payment to the surety.

(f) Upon completion and acceptance of all work, the amount due the Contractor under this contract shall be payed upon the presentation of a properly executed voucher and after the Contractor shall have furnished the Government with a release of all claims against the Government arising by virtue of this contract, other than claims in stated amounts as may be specifically excepted by the Contractor from the operation of the release. If the Contractor's claim to amounts payable under the contract has been assigned under the Assignment of Claims Act of 1940, as amended (31 U.S.C. 203, 41 U.S.C. 15), a release may also be required of the assignee.

PAYMENTS TO CONTRACTOR (10 CFR 1-7.602-7)

(a) The Government will pay the contract price as hereinafter provided.

(b) The Government will make progress payments monthly as the work proceeds, or at more frequent intervals as determined by the Contracting Officer, on estimates approved by the Contracting Officer. If requested by the Contracting Officer, the Contractor shall furnish a breakdown of the total contract price showing the amount included therein for each principal category of the work, in such detail as requested, to provide a basis for determining progress payments. In the preparation of estimates the Contracting Officer, at his discretion, may authorize material delivered on the site and preparatory work done to be taken into consideration. Material delivered to the Contractor at locations other than the site may also be taken into consideration (1) if such consideration is specifically authorized by the contract and (2) if the Contractor furnishes satisfactory evidence that he has acquired title to such material and that it will be utilized on the work covered by this contract.

(c) In making such progress payments, there shall be retained 10 percent of the estimated amount until final completion and acceptance of the contract work. However, if the Contracting Officer finds that satisfactory progress was achieved during any period for which a progress payment is to be made, he may authorize such payment to be made in full without retainage of a percentage. Also, whenever the work is substantially complete, the Contracting Officer shall retain an amount he considers adequate for protection of the Government and, at his discretion, may release to the Contractor all or a portion of any excess amount. Furthermore, on completion and acceptance of each separate building, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made therefore without retention of a percentage.

(d) All material and work covered by progress payments made shall thereupon become the sole property of the Government, but this provision shall not be construed as relieving the Contractor from the sole responsibility for all material and work upon which payments have been made or the restoration of any damaged work, or as waiving the right of the Government to require the fulfillment of all of the terms of the contract.

(e) If Miller Act (40 U.S.C. 270a–270e) performance of payment bonds are required under this contract, the Government shall pay to the Contractor the total premiums paid by the contractor to obtain the bonds. This payment shall be paid at one time to the contractor together with the first progress payment otherwise due after the contractor has (1) furnished the bonds (including coinsurance and reinsurance agreements, when applicable), and (2) furnished evidence of full payment to the surety company, and (3) submitted a request for such payment. The payment by the Government of the bond premiums to the contractor shall not be made as increments of the individual progress payments and shall not be in addition to the contract price.

(f) Upon completion and acceptance of all work, the amount due the Contractor under this contract shall be paid upon the presentation of a properly executed voucher and after the Contractor furnished the Government with a release of all claims against the Government arising by virtue of this contract, other than claims in stated amounts as may be specifically excepted by the Contractor from the operation of the release. If the Contractor's claim to amounts payable under the contract has been assigned under the Assignment of Claims Act of 1940, as amended (31 U.S.C. 203, 41 U.S.C. 15), a release may also be required of the assignee.

APPENDIX B

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE,
Washington. D.C., March 4, 1982.

Memorandum for the Assistant Secretary of the Army (IL&FM), Assistant Secretary of the Navy (S&L), Assistant Secretary of the Air Force (MRA&I).

Subject: Department of Defense Policy on Retainage.

Interest on commercial construction loans remains high and we must expect that the carrying cost on retained payment will be included in contract bids. Current construction contract retainage practices are likely to add costs to our construction program, therefore, and do not necessarily improve the quality or utility of the project. By controlling retainage on our contracts, we should realize economic savings in Department of Defense construction. The objective of this policy statement is to reduce our construction program costs and still permit Construction Agents to manage their contract effort in a businesslike manner.

As a matter of Department of Defense policy, retainage will not be routinely used throughout the term of contracts for construction projects which are on or ahead of schedule and otherwise substantially in compliance with contract requirements. Some level of retainage may be used as the contract approaches completion, however, to ensure that construction deficiencies are corrected promptly and that completion is timely. Further, in specific cases, where past unsatisfactory performance by a certain contractor has been experienced or there is another valid consideration relating to a particular contract, the Construction Agent may elect to withhold retainage throughout the term of the contract if that will be in the best interest of the government. Construction Agents are to exercise these options with discretion and for specific justification. Retainage will no longer be a routine administrative practice.

This policy on retainage must be complemented by prompt and positive final payment procedure after a contractor has completed all contract requirements. This should improve our perception as a preferred customer by the construction industry and tend to reduce our contract construction costs even more.

ROBERT A. STONE,
Deputy Assistant Secretary of Defense,
(Facilities, Environment, and Economic Adjustment).

APPENDIX C

Text of U.S. Commission on Government Procurement Final Report on subject of Retainage

The retained percentage: It is common practice for Federal agencies (and non-Federal Governmental agencies) to withhold 10 percent of progress payments until the contract is 50 percent complete. On a contract of $10 million the Government will withhold $500,000 which serves to increase the contractor's borrowings by a like amount and these costs are now being included in the bid prices. The GAO estimates Federally financed construction contracts for 1970 at about $30 billion; thus, at 9 percent interest the retained percentage could be costing the Government construction procurement more than $30,700,000 per year or approximately $84,000 per calendar day. The following table shows the estimated annual savings:

GAO estimate of construction contracts involving Federal funds	$30,000,000,000
Monthly outlay of above	$2,500,000,000
Average retention (percent)	7.5
Monthly retention	$115,000,000
Interest rate to contractors (percent)	9
Cost of capital to contractors (assumes uniform series with LS payment at end of year)	$79,000,000
(A) This is what is passed on to taxpayer	$79,000,000
(B) If retention eliminated, cost of additional Government borrowing estimated at 5½ percent	$43,300,000
(A–B) Net cost to taxpayer of current retention system (per year)	$30,700,000
Potential Federal savings (per year):	
Direct construction	$5,100,000
Grant construction	$7,600,000
Total	$12,700,000

Federal agencies defend the custom as being necessary to insure that the contractor will complete his contract in an expeditious manner; however, most administrators agree that retention is really only needed if contractor is falling behind schedule or at the end of the construction period as his incentive to finish the work.

The surety industry has major objection to reducing the current requirements as to retained percentage. They point out that a substantial "retainer" is occasionally the only factor that persuades a contractor to stay on the job. The sureties readily admit that the bonding company is the principal beneficiary if the retained percentage were reduced from the now 5 percent maximum to 1 percent maximum would be offset by either increase in bond premiums or increase difficulty in administering construction contracts or both.

One solution that both the contractors and sureties agree on is the substitution of contractor-owned approved securities for the retained percentage. The Interior Department is now permitting this on some construction contracts as are the States of Arkansas, California, Connecticut, Maine, Montana, New Hampshire, New York, North Dakota, Oklahoma, Pennsylvania, Rhode Island. Utah, West Virginia, Wyoming, Washington, and Tennessee.

One Federal agency objected to the proposal on the basis that "this is not practical because the U.S. Treasury would have to borrow additional money to cover the increase deficit." This assumption that somehow the contractor should participate in financing the project is difficult to understand, especially when the Government usually borrows at less than the prime bank rate while the contractor usually pays an effective interest rate considerably above the prime rate. However, if the concept is accepted the estimated savings would be substantially less.

If certificates of deposits are accepted, the cost to the contractor would be reduced from $79,000,000 to $30,700,000 or a savings in contractor financing of $48.3 million per year. This assumes the same 9 percent interest rate and a bank interest rate of 5.5 percent paid on the certificates of deposit. Under competitive bidding system this savings would be passed on to the taxpayer in lower bid prices (pgs. 70–73).

Recommendation: that FPR and ASPR be amended to permit as normal practice the elimination of retainage on progress payments provided the contract is on schedule. That retention be limited to that required to assure completion of remaining work near the end of construction. As an alternate, that retained funds be paid the contractor when and if he deposits in escrow eligible securities or bank certificates of deposit (p. 31).

APPENDIX D

TEXT OF H.R. 5022 AND S. 1782

To amend section 305 of the Federal Property and administrative Services Act of 1949 pertaining to contract progress payments made by agencies of the Federal Government, to provide for the elimination of retainage in certain instances, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section I. This Act may be cited as the "Small Business Contract Payment Procedures Act."

Section II. Section 305 of the Federal Property and Administrative Service Act of 1949 (41 U.S.C. 255) is amended by adding at the end thereof the following:

(d) Whenever an executive agency makes progress payments under the authority of subsection (a)(1);

(1) Such progress payments shall be made monthly as the work proceeds, at more frequent intervals as determined by the contracting officer, or at intervals stipulated by the contract;

(2) If the contracting officer finds that satisfactory progress toward completion of performance of the contract was achieved during any period for which a progress payment is to be made he shall authorize such payment to be made in full without retention of any percentage of the contract price; and

(3) If the party performing the contract is a small business concern, as defined in section 3 of the Small Business Act, which has furnished an adequate performance bond, as determined by the contracting officer, he shall authorize such payment to be made in full without retention of any percentage of the contract price."

Mr. MITCHELL. Mr. Lavallee please proceed.

TESTIMONY OF DENNIS LAVALLEE, MEMBER, EXECUTIVE COMMITTEE, SMALL BUSINESS LEGISLATIVE COUNCIL, AND DIRECTOR OF GOVERNMENT AFFAIRS, NATIONAL ASSOCIATION OF PLUMBING-HEATING-COOLING CONTRACTORS

Mr. LAVALLEE. Mr. Chairman and members of the subcommittee, my name is Dennis Lavallee and I am a member of the executive committee of the Small Business Legislative Council or SBLC. In addition, I am director of government affairs for the National Association of Plumbing-Heating-Cooling Contractors.

The Small Business Legislative Council is a coalition of 75 national business and trade associations. Our members represent about 4½ million small business units and cover just about the full range of SIC classifications.

The National Association of Plumbing-Heating-Cooling Contractors is the oldest national association in the construction industry. It has over 6,400 members. Membership comes from every State in the country and is organized through about 300 State and local affiliated associations. This industry employs over 400,000 people and has receipts of over $21 billion.

The SBLC is pleased to have the opportunity to testify in support of the elimination of retainage on Federal construction expressed in H.R. 5022, the Small Business Contract Payments Procedures Act. Our position paper (attachment A), has been approved by the SBLC executive committee and is currently pending before our various member organizations as we await their approvals to be listed in support.

Retainage directly affects the various construction contractors which make up a major sector of our Nation's gross national product. However, it also affects the many small businesses which contract for construction work by increasing their costs of construction.

In early days, Government agencies usually dealt with a single general contractor who performed most of the construction work with his own employees. Agencies withheld a portion of each progress payment as leverage to insure that the work would be completed satisfactorily.

Today, more than 50 percent of the work is subcontracted to a wide range of different types of subcontractors. Performance bonds are required of prime contractors to guarantee that the project will be completed satisfactorily. Likewise, prime contractors require performance bonds from their subcontractors.

However, retainage is still withheld from payments to the contractor to insure completion. Naturally, the prime contractor is not likely to pay his subcontractors from his own pockets and, therefore, he withholds a corresponding amount from them.

Recently, the National Association of Plumbing-Heating-Cooling Contractors completed an extensive survey, which is called Probe, of contractor members on retainage and a sample of the Probe is attached to the statement which you have (attachment B). I was asked to present results of that survey on behalf of the SBLC. There are five major conclusions that can be drawn from the Probe that impact on retainage.

One, retainage provides a duplicate layer of protection which the Government pays a premium for. According to the results of the survey, 62 percent of plumbing-heating-cooling contractors admit that they increase their bids on construction to cover the costs of retainage. The median increase was 3 percent of the contract price, but more than a quarter of the respondents indicated that their increases ranged from 5 to 15 percent. Contractors also add the costs of their performance bond to the bid. The median increase in bid was 1¼ percent. Thus, the Government is paying a total of 4¼ percent over the actual costs of the construction contract for the dual level of protection. Incidentally, this is a cost that the subcontractor passes on. The prime contractor, of course, passes on his costs for retainage in the performance bond. This is even more ironic since the Federal Government has been seeking to eliminate duplicative regulations to reduce costs.

Two, retainage is an unnecessary layer of protection. While proponents of retainage believe that it encourages completion of a contract, 63 percent of the contractors responding said that retainage is not an effective method to get contractors to complete the punchlist. Thus, if it is not a motivating factor for the contractors who will do the work, it is obviously unnecessary.

Three, the elimination of retainage will stimulate increased competition. Increased competition contributes to lower costs and a healthier economy. When asked if retainage were eliminated, would contractors be more likely to bid more jobs, a significant 48 percent said they would be likely to bid more jobs.

Retainage forces contractors to borrow money to meet the demands of the contract. Although a contractor must pay the bills of suppliers and meet his payroll and cover other overhead costs, as has been discussed by other witnesses, he is not receiving full compensation for the efforts of his company. Many contractors borrow to meet those obligations until they have received those retained funds. With the elimination of retainage, contractors will have more financial flexibility to bid more jobs. This will increase competition for Government contracts and bring costs down.

Four, the elimination of retainage will free up valuably needed cash flow. Survey results indicate that generally up to 10 percent is withheld from each progress payment. These are funds that are not available to the contractor for the conduct of his business. In fact, a contractor must run at a negative cash flow as he meets his supplier, labor and overhead obligations for fulfilling the contract. Thus, a contractor must borrow funds at current market rates, as has been mentioned, to pay his bills until the retainage is received.

If retainage were eliminated and full progress payment made, contractors would have the necessary operating capital for expansion, seeking new contract opportunities and producing new jobs. This is a goal which is important to small businesses, but frequently restrained from contractors because of retainage.

Five, the elimination of retainage speeds up job completion. There is more urgency to complete a job if a contractor knows that full payment will be forthcoming quickly. The NAPHCC Probe found that the median delay in receipt of full final payment, including all retainage, after completion of work, was 4 months. A quarter of the contractors reported waiting 7 months or more. This is in addition to waiting for payment during the course of construction.

Thus, a contractor is waiting a significant amount of time for money he is entitled to. These are funds which he has no access to for ongoing operations and, in fact, cannot even earn any interest on. Other subcontractors face a far worse predicament. Those contractors, such as masonry or others, who arrive at the construction site long before the plumbing-heating-cooling contractor must wait still longer periods of time for their retainage.

If a contractor can expect to be paid in full for all work completed, that contractor is far more likely to complete the contract quickly to enable him to receive all payments as quickly as possible.

The Small Business Legislative Council believes that bonding should be used as the single, best source of protection. Where there are no bonding requirements or where bonding requirements have been waived to assist struggling firms such as new companies or minority or female-owned enterprises, the percentage retained should be as low as possible. Release of funds should be done on a line item basis with each subcontractor's work considered as a separate item so that firms are not left waiting for final payment. Any retained funds should be held in an escrow account with interest accruing to the benefits of the contractor.

Furthermore, it is important to note that the practices of the Federal Government are watched and followed by State and local government and private owners. Therefore, a public policy decision by Congress enacted through this legislation would lead the way to the elimination of retainage on many types of construction. Thus, savings experienced by the Federal Government as a result of elimination could be enjoyed by all small businesses planning construction work.

However, we do have one recommendation to significantly improve H.R. 5022. The bill should have language which insures that the prime contractor also eliminates the holding of retainage for his subcontractors. It would be a sham to the entire legislative process if legislation were passed eliminating retainage on prime contractors, but not reaching beyond that. A prime contractor might be very tempted to withhold retainage on his subcontractors to earn interest on the funds. Meanwhile, the benefits and savings are not passed on to the subcontractors or to the owners.

Mr. Chairman, and members of the subcommittee, in conclusion, we support the thrust and intent of H.R. 5022 to eliminate retainage on Federal construction. We believe that Congress should eliminate this duplicative and unnecessary layer of protection. Elimination will stimulate competition, free up valuable cash flow for small businesses and speed up completion of construction. Bonding should be used as the single best source of protection.

However, we urge the Congress to incorporate so-called flow down provisions in the bill, which insure that when retainage is eliminated, payments are made to both prime and subcontractors.

Thank you, and I would be happy to answer any questions.

[Attachments referred to in testimony follow:]

Attachment A.

POSITION PAPER

ELIMINATION OF RETAINAGES

Retainage is the process under which a procuring agency will hold back part of the payment for work that has been completed as an incentive for a contractor to complete the job.

Elimination of retainages is an area that promises tremendous savings to the government. Traditionally, a certain percentage of payments are retained until construction is complete. This is to insure completion of the work. Naturally, the contractor factors this loss of use of funds into his bid. However, the contractor must also factor in the cost of his performance bond which insures completion of the work. Thus, by requiring both retainages and a performance bond, the government is paying for an unnecessary double layer of protection.

However, there is a significant body of opinion that believes both retainage and a performance bond are needed. Where retainage is held, the amount should be kept to a minimum. Contractors are obliged to pay higher interest rates on funds borrowed for working capital to offset retentions, thereby increasing construction costs. Therefore, retained funds, which have been earned by the contractor, should be placed in an interest bearing escrow account for payment to the contractor. Likewise, contractors should receive interest on late payments for all construction work completed.

RESOLVED

The Small Business Legislative Council supports Elimination of Retainages. Bonding shoud be used as the single, best source of protection. This should apply to prime and subcontractor equally, but where a company is unable to obtain bonding, retainage may be used as an alternative.

Where there are no bonding requirements, the percentage retained should be as low as possible, in no case more than 5%, until 50% of the work is completed, and then dropped.

The percentage level of any retention should be the same for subcontractors as for prime contractors on a job.

Release of retained funds and final payment, as well as figuring the point of reduction of retainage, should be done on a line item basis...that is, each contractor or subcontractor's work considered as a separate item.

Retained funds should be held in an escrow account with interest accruing to the benefit of the party to whom the funds are due.

Interest should be paid on late payments for complete work.

Attachment B

PROBE '82

A Survey of Plumbing-Heating-Cooling Contractors - March, 1982

Dear Friend,

The NAPHCC Legislative Committee has been working with our sister organizations to deal with the problems caused by retainages on construction contracts in the public and private sector. Toward this end, we ask for your cooperation by answering the following Probe.

Sincerely,

Leonard X. Farbman, Chairman
NAPHCC Legislative Committee

Legislative Committee

William L. Harvey
Charles R. Blank, Jr.
John Mirlisena
Karl Ruch
James E. Curry

Impact of Retainage

1. Do you believe that retainage is an effective method to get contractors to complete the punch list?

☐ Yes
☐ No
☐ Don't know/no opinion

2. Do you increase your bids to cover your expected costs of retainage?

☐ Yes
☐ No
☐ Does not apply

3. If yes, approximately how much? ________%.

4. If retainage were eliminated, how likely would you be to bid more jobs?

☐ more likely
☐ about the same as currently
☐ less likely

Amount of Retainage Outstanding

5. Approximately what share of your volume is from federal contracts?

Federal ______%

Nonfederal/other ______%

6. On the average, approximately what is the percentage of retainage withheld?

Federal ______ %

Nonfederal/other ______ %

7. Approximately what is your gross volume?

☐ less than $100,000
☐ $100,000 to $250,000
☐ $250,000 to $500,000
☐ $500,000 to $1 million
☐ $1 million to $2.5 million
☐ $2.5 million to $5 million
☐ $5 million to $7.5 million
☐ over $7.5 million

Published by the National Association of Plumbing-Heating-Cooling Contractors, 1016 20th Street, N.W., Washington, D.C. 20036 - (202) 331-7675

8. On this volume, how much cash is retained on the average?

$ ______________

9. On the average, how long is it held?

______________ months

10. Right now, how much retainage do you have outstanding (i.e. on which you are waiting for payment)?

$ ________________

Performance Bonds

11. Of your contracts that have retainage held what proportion also require performance bonds?

_______%

12. What is the average cost added to your jobs for the performance bonds?

_______%

Accounting Method

13. Which of the following accounting methods do you use?

☐ cash

☐ accrual

☐ completed contract method

☐ other (specify__________________)

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Plumbing-Heating-Cooling Contractors
1016 20th Street, N.W.
Washington, DC 20036

Mr. Mitchell. Thank you very much and thank all four of the witnesses. Let me assure you that the recommendations that several of you made with reference to flow down or passthrough, will be entertained by this committee. We certainly want to take a look at that in an attempt to make the bill beneficial to as many people as possible.

I am a little concerned that because of retainage those bidding might increase their bid from a low of about 5 percent. I think there was a consensus on that, to a high of 15 percent?

Mr. Lavallee. Five to 15 percent were the ranges in the upper quartile of the survey, that is correct. It is because of the waiting time and the increased costs of interest which they need to pay to cover their operating cost. There were some of our respondents who indicated that they increased their bids as high as 15 percent.

Mr. Mitchell. It seems we could save a lot of money.

Another area that I wanted to look at, and this is not directly related to the bill, but I am curious. When the prime is finally paid, has there been an experience of the delay between the time that he is paid and the money gets to the subs?

Mr. Knott. There has always been a delay in that and the passthrough would greatly aid that, but there has always been a delay in after the prime is paid, when the money is paid down to the subcontractors. The majority of primes pay very promptly. You always have a certain percentage that don't, but it seems like the percentage that don't normally get a lot of work.

Also, the retainage along with the bonding eliminates a lot of people from bidding on Government work. If they have to be bonded and then they have the responsibility of the retainage on top of that, it kind of sets a lead core of people who are able to finance. People with a lot of money can finance it better and, therefore, they can bid the work and it eliminates a lot of bidding.

Mr. Mitchell. Precisely, that is the reason why you see some almost monopolistic practices taking place in reference to Government contracts. Big guys can afford to wait it out.

Mr. Knott. The city of Baltimore has experienced that. They have reduced their retainage to 5 percent for the first 50 percent and then none thereafter, which is a net of 2½ and they have experienced more and more contractors bidding their work because of that.

Mr. Mitchell. Let me work with my city councilman and see if he can't eliminate it altogether.

Mr. Knott. It would be very nice.

Mr. Lavallee. In fact, it has been reported that years ago those contractors who were better financed liked the idea of retainage because it tended to narrow down the competition and they had a better shot at it.

Mr. Mitchell. I have just one other question.

You cited the *Indiana* case, didn't you, the *Indiana* court case?

Mr. Wilkinson. In my written testimony, I did.

Mr. Mitchell. I am curious about that case. Did the court rule that the retainage policy was unfair?

Mr. Wilkinson. The court ruled that the general contractor was withholding the money for an unreasonable period of time and the subcontract could not be interpreted to allow him to do that.

Mr. **Mitchell**. But it did not deal with the merits of retainage?

Mr. **Wilkinson**. Not with retainage itself, no, sir.

Mr. **Mitchell**. Thank you. Mr. Daub.

Mr. **Daub**. Thank you, Mr. Chairman.

I would like to indicate to you that Representative McDade is unable to be here this morning due to an important Appropriations Committee meeting. He has requested that I express his regrets that he cannot attend. Mr. McDade has agreed to cosponsor your retainage bill, H.R. 5022, and he feels that this hearing is important for raising this issue in connection with retainage.

In addition, he wanted me to express his appreciation for the work of Mr. John Sataga, his apprecation for this man who works with the Door & Hardware Institute, who has done so much to help bring this issue to the committee's attention at this time.

At this time, I would like to ask that Mr. McDade's opening statement be entered in the record.

Mr. **Mitchell**. I will be delighted to see that that is entered into the record.

Opening Statement of Hon. Joseph M. McDade, a Representative in Congress from the State of Pennsylvania

Mr. Chairman, today's hearing focuses on a matter of great concern to prime contractors, subcontractors, and the Government, which does a large volume of construction contracting. Under the practice of "retainage," the Federal Government retains up to 10 percent of the progress payments that are due construction contractors for work already completed. This may not only be obsolete, but it may also cost the Government extra money on contracts. It appears that bidders may load bids in order to compensate for the monies lost because of retainage. Also, retainage may slow down Government construction because there is no incentive for subcontractors to complete their work as quickly as possible.

One thing is definitely clear: Retainage presents small contractors and subcontractors with "cash flow" problems. While they must make their payments without delay, Government contractors must wait until the job is long done before being paid fully for their work. The monies that small contractors lose to retainage are often the small margins on which small contractors operate. Often, in order to meet costs, these contractors and subcontractors must borrow to meet their operating funds, and we all know what that amounts to with today's interest rates. Reports are that some small businesses have simply stopped bidding for Government contracts because of retainage.

Of course, we must protect the Government when it contracts for work, but today we must examine whether retainage in fact diminishes the Government's ability to get work done cheaply and on time.

Mr. **Daub**. Mr. Chairman, I have a witness to introduce to this subcommittee on this subject, a Mr. Thomas Furey, who will testify in the next panel. So, if I might, I will hold my opening statement and my questions until that panel comes.

Mr. **Mitchell**. Thank you. Surely, you can do that.

Mr. Hatcher, any questions?

Mr. **Hatcher**. No, sir.

Mr. **Mitchell**. Mr. Hiler.

Mr. **Hiler**. Thank you, Mr. Chairman.

Let me direct the question to any of the four: As it relates to the flow through from the prime to the subcontractor, what is to prevent the subcontractor—if retainage is eliminated to the prime contractor—from putting into his contract with the prime contractor that retainage will not be acceptable?

Mr. **Wilkinson**. Mr. Hiler, I would like to take a first crack at that and I am sure the others will, too.

At the time that the subcontract is negotiated, so to speak, the subcontractor is in a very weak negotiating position. The prime contractor, the general contractor, already has the job. The subcontractor is still trying to get the job; even though the prime contractor used his bid, he has no assurance that he is going to get the job. His ability to write things into the subcontract which are beneficial to him are limited.

Now, we feel that subcontractors should be tougher on this subject than they are, but the only other choice is not to do the job and this, of course, further reduces competition. It is very difficult for a subcontractor to dictate the terms of the subcontract.

Mr. **Hiler**. But, theoretically, the prime contractor is trying to find the lowest cost arrangement. Is that correct?

Mr. **Wilkinson**. Yes.

Mr. **Hiler**. Well, then, theoretically, if there are two subcontractors bidding and one offers less cost to the prime, then wouldn't you have an overall lower cost for the entire project? I am not questioning the fact that the prices are bid up anywhere from 5 to 15 percent, but I am wondering how that flows through to the subcontractor if you eliminate retainage to the prime contractor to begin with—if that is no longer considered acceptable to the prime contractor.

Mr. **Knott**. If you eliminate and you have a flow through to the subcontractor when he initially bids the job, he will give the lowest price and that money will come off then. What does happen presently is the general contractor will sit there and he will say here is my contract. You sign my contract the way it is right now or I will give the job to someone else and that is the way the business is run.

Mr. **Hiler**. But he is not going to give it to someone else who is going to charge more?

Mr. **Knott**. No, that is correct.

Mr. **Hiler**. OK. Well, the assumption that you make that the subcontractor would come in with the lowest price if there was no retainage is——

Mr. **Knott**. Well, that is what a lot of the theory of this whole thing is and it is well-founded and that is what we believe. What happens though, in reality, if there is no passthrough, the general contractor will hold the money even if he can get a better price. He might save $5,000, but if he can hold $500,000 in retainage on a total contract, in the money markets today, at 14, or 15 percent, he can do a lot better than that and once he gets the contract he has the bid. He has to do it for that.

Mr. **Bachand**. I would just like to take one shot at that.

Mr. **Hiler**. Sure.

Mr. **Bachand**. Usually when we give a price it is a price between the general contractor and ourselves. We have spent a lot of time fighting retainage with the general contractors, so we know what it is like. It is a principle thing with him in most cases and he can quickly hand your price over to somebody else and say will you take it for this price and our competitors will do that. So, he is not going to pay any more. There is no question about that and he will stand behind that principle of the 10 percent. We have taken a strong stand. We have lost jobs because of it and we will only take a job with retainage if they put some restrictions on the retainage in terms of when our portion of the job is completed we want to be paid within 30 days after that, regardless of how the entire project goes one way or the other. That is what we try to do. We don't always get away with it and sometimes we need the work more than we go into the principle, but we do try to fight it as much as possible.

Mr. **Hiler**. OK. I guess my question is that it would seem to me that if you eliminate retainage to the prime, which, say, the Government could do, then the prime contractor would be looking for the lowest price that he could find. If the project is going to be done in the most efficient, economical manner; if the prime knows he is not having any retainage and he has to go out and find subcontractors who are going to give him the lowest price, if 3 to 5 to 15 percent is being added onto the cost to account for retainage; if someone says we don't have retainage and this is our price, wouldn't it follow through then that you are going to have a better competitor——

Mr. **Wilkinson**. Mr. Hiler, what is going to happen in this case is that the subcontractors will—they are eternally optimistic—think since the general contractor is not going to pay retainage, when they bid the job they will give him a firm bid without the 5 or 15 percent, assuming there will be no retainage. Then from that point on, it becomes a matter of negotiation. Unfortunately, there will be some, as the other two witnesses have said, who are going to capitulate and somebody will come along who is willing to take a chance——

Mr. **Hiler**. That is the old S.O.B. theory, but that is what prevents monopolies. That is what my old economics teacher always said. The S.O.B. theory always prevents monopolies, but—what about this court case that someone—did you say it, sir?

Mr. **Wilkinson**. Yes.

Mr. **Hiler**. The courts have ruled that only unreasonable retainage to a subcontractor——

Mr. **Wilkinson**. This didn't pertain specifically to retainage. This pertains to the question of when the general contractor is to pay the subcontractor his final payment, including the retained percentage. In the court case I cited—and there have been quite a few like it—the prime contractor, the general contractor, was having less retained by the owner than was being retained from the subcontractors. Therefore, the longer he delayed final payment, the more money he was making because he was investing the difference. The general contractor was able to delay final completion just by not doing all of his punchlist work. So, his subcontract said he would pay the subcontractors upon receipt of his payment from the owner. He delayed receiving payment from the owner, according to the judge deliberately, to avoid paying the subcontractors.

Now, in that case and in some others after several months and the cost of going to court, the judge said this is an unreasonable interpretation of the subcontract. I won't allow you to do it. You have to pay the subcontractors whether you get your final payment or not, but this, of course, means that most of the cost of retainage went for legal fees and it was 2 years in that *Indiana* case. It was 2 years after the subcontractors had completed before they got to court. So, there was still a very substantial delay. The judge did not deal, as I recall it, specifically with the question of whether the retainage itself was reasonable.

Mr. Hiler. Let me ask one final question: If the flow through were mandated in the law, how would you want to see it specified? That payment would have to be made under normal terms of commercial code, under normal 30-day terms, under normal terms of contract between prime and sub?

Mr. Knott. Under the same terms of the contract that the general contractor has with the owner, the owner being the Federal Government, that if he is paid within 30 days, then the sub be paid within that same timeframe, so that we are all working under the same rules and regulations. We don't want anything different than what the general contractor is provided.

I think one thing that is worthy of noting is that most subcontractors start out—if you are a plumber, you start out and you have a truck or you have a station wagon and you throw your tools in there and you start jobbing work and then you gradually build up and if you want to expand and to become larger, then you go out into the bidding world and you start, and the retainage is what is really hurting the subcontractors. They are out there bidding. Most of them are not sophisticated businessmen. They haven't taken any economics courses. They don't know anything about accounting and they don't really know what the cost of that retainage is to them.

Consequently, a lot of those people, of the small people who want to start are going under and retainage has put a tremendous amount of them under.

Mr. Wilkinson. Mr. Chairman, we do have proposed wording on this subject if you would like me to read it.

Mr. Mitchell. That would be beneficial, yes.

Mr. Wilkinson. This was prepared by the attorney for the Sheet Metal and Air Conditioning Contractors Association, section E:

> Executive agencies shall require (1) all parties receiving payments pursuant to Subsections D(2) and D(3) to immediately pay their subcontractors in full without retention of any percentages of the contract price for all work performed by the subcontractor. And, (2) all subcontractors receiving payments pursuant to Subsection E(1) of this subsection to pay their subcontractors, if any, in full without retention of any percentage of the contract price for all work performed by the subcontractors.

Mr. Hiler. What do you define as "immediately"? That is, the 30 days?

Mr. Wilkinson. I think normally under commercial practices, 30 days, yes, sir.

Mr. Mitchell. If you will leave a copy of that with us, I have some questions about the language, but at least that is a start.

Mr. Hiler. Now, what happens if it hasn't been paid in 30 days? Let's say he goes 45 or 60 days and accounts receivable extended? Would you still have to go through the court system? That happens every day. You have private work, as well, that goes beyond 30 days, I am sure, and probably most business people from time to time go beyond 30 days themselves in dealing with folks. You would still have to go back to the court system.

Mr. **Lavallee**. Well, certainly, in terms of the Federal Government's dealings with a prime contractor, the Congress is very close to finishing work on the Prompt Payment Act. That would become a part of the solution, in which the prime contractor would have to be paid or be subject to interest penalties. Once the prime contractor has been paid with the flow down provisions, there is then a payment to the subcontractors. So, I think with the two in tandem, they will work to take care of that problem.

Mr. **Bachand**. I think we also have the right to pull off the job or stop work on the project if we are not paid within the terms, the same way he is. So, we have that leverage. We don't have to go necessarily back to the courts. We can just stop work.

Mr. **Hiler**. No further questions, Mr. Chairman.

Mr. **Mitchell**. Gentlemen, thank you very, very much for being here. If you will leave that language recommendation with us, please.

I would like, with your indulgence, to change the order just a bit. I understand that Mr. Stone, who is the Deputy Assistant Secretary of the Department of Defense, for Facilities, Environment, and Economic Adjustment has recently had surgery and should not be on his feet, or should rest frequently. So, I should like to move you up in the order, if I may, and I would like to recommend that you sort of capsulize your testimony. What we are primarily interested in is, No. 1, did, indeed, DOD eliminate the retainage requirement and two, if you did that, what were the reasons for it. Thank you, sir.

TESTIMONY OF ROBERT A. STONE, DEPUTY ASSISTANT SECRETARY OF DEFENSE FACILITIES, ENVIRONMENT, AND ECONOMIC ADJUSTMENT, DEPARTMENT OF DEFENSE, ACCOMPANIED BY COL. ROBERT GLOGAL, ASSISTANT DIRECTOR OF CONSTRUCTION

Mr. **Stone**. OK, Mr. Chairman, I appreciate your indulgence in changing the order. It will certainly be better on me physically.

I am accompanied by Col. Robert Glogal, who is our Assistant Director of Construction in the Department of Defense. I have a short statement, which I would like to enter into the record and let me just say a couple of things about it.

Mr. **Mitchell**. Without objection, your entire statement will be submitted for the record.

[Mr. Stone's prepared statement follows:]

Prepared Statement of Robert A. Stone, Deputy Assistant Secretary of Defense Facilities, Environment, and Economic Adjustment, Department of Defense

Mr. Chairman and members of the committee, I am pleased to have this opportunity to appear before your committee to discuss retainage of payments on military construction contracts. We define retainage as the withholding of some percentage of a contractor's request for payments, until the contract is satisfactorily completed at a later date.

In the past, Department of Defense practice was routinely to retain 10 percent of payments for completed work. Discussions with the industry, (in particular with the American Subcontractor's Association), with several other Federal Agencies, and with the U.S. Army Corps of Engineers and the Naval Facilities Engineering Command, led us to conclude that this "retainage" was adding cost to our contracts, while adding nothing to the quality of the project. This added cost was the interest that contractors were incurring on the commercial loans they carried to make up the withheld funds. We were not able to accurately estimate this added cost, but were satisfied that there were savings to be realized by avoiding that cost. We further concluded that through our retainage practice we were reducing the competition on our projects by discouraging some contractors from bidding on our work.

The retainage practice was thought by some to be a useful tool to ensure that a contractor would complete a contract. However, on balance we concluded that careful management during the contract could just as well ensure successful contract completion. Management would have to exercise caution in not making progress payments that were not justified. A contractor should be paid only for satisfactorily completed work. Management might need some retainage at the final period of a contract to encourage the contractor to complete the contract in a timely manner.

We issued a new statement of policy in a letter of February 3, 1982. The new policy eliminates the routine use of retainage throughout the term of contracts for construction projects that are on or ahead of schedule, and are otherwise substantially in compliance with contract documents. Our policy does permit management to retain some level of payment as a contract approaches completion to ensure that construction deficiencies are corrected promptly and that completion is timely.

We recognize that there may be specific reasons on certain contracts to retain payments. In certain cases, where past unsatisfactory performance by a certain contractor has been experienced or there is another valid consideration relating to a particular contract, management may elect to retain some payments throughout the term of the contract if that will be in the best interest of the government. This exception is to be used with discretion, and only for specific justification.

We expect to save money on military construction because of this new policy. The costs of retained payments will not be incurred by contractors, and we expect their bids to be reduced accordingly. Our new policy should make us a more favored customer of the industry, increase competition, and through this increased competition result in lower bids.

Because our policy is still quite new, we have no statistics on data that are available on its implementation. The policy applies to contracts now being awarded but not to those that have been awarded in the past and were underway when our policy was issued. The policy has been widely disseminated through Department of Defense channels, through the media, and through trade association publications. We have received no information from the industry that would suggest that the policy is not being followed. And the industry is normally quick to let us know when a new policy we have announced is not being followed.

Gentlemen, that concludes my remarks. I will be pleased to answer any question you may have on our policy.

Mr. STONE. In the past our policy was routinely to retain 10 percent of the payments due the contractor until the end of the contract. A number of discussions with the professionals in the field led us to conclude that we were driving up costs. We were imposing costs on the contractors—costs which weren't benefiting us in terms of better construction or better performance. So, we set about to eliminate the routine use of retainage, and I directed the construction people in the military departments in February to stop routinely retaining payments on military construction contracts.

My letter to them allowed them to retain some payments in the latter stages of contracts where the construction agents thought it was necessary in order to insure that things got wrapped up, or to retain on contracts where they had some specific reason, where there was a contractor who had performed badly in the past or, perhaps some other reason in their judgment. We told them that if they were going to do it, they had better have a reason for it. The reason that we did this in the Department of Defense was we believed it would save money.

I would like to put the savings in perspective, at least in our perspective, because I think some numbers have been talked about here that are much different than the way that I see it. If we look at a typical military construction project that lasts 18 months, if we retain money throughout, we retain the contractor's money for an average of 9 months; that is, we pay him 18 months late for his first month's work and just 1 month late for his last month's work. So, we are holding his money for an average of three quarters of a year. If he is paying 20 percent interest on his money, we are imposing on him, an interest cost of three quarters of a year times 20 percent, or 15 percent of what we retain.

If our retainage is 10 percent, we are imposing on him a cost equal to 1½ percent of the contract. So, if our policy were to go from retaining everywhere to absolutely no retainage under any circumstances, we would expect to reduce the contractor's cost by about 1½ percent.

Now, in fact, we are not going quite that far because we don't retain universally today. There are some contracts on which there is no retainage, and our new policy does allow some retainage. So, we know it is something below 1½ percent of our cost that we ought to be saving. I would guess it is somewhere around half of that; that is, about three-quarters of a percent for the cost of our contracts.

The policy is new, as I say. We issued it in February. Our reading to date is that it is being implemented, but we don't have any data on its implementation. One of the benefits we have in the Department of Defense is we have a lot of people who will tell us if a new policy is not being implemented. So, our method is to publicize the new policy. It has gotten a lot of publicity in the trade journals and if retainage is being mindlessly applied still on construction contracts, we expect to hear about it.

That concludes my summary, Mr. Chairman.

Mr. MITCHELL. Thank you. May we have a copy of the letter that you sent, and could we have a copy of the policy itself? Surely we would like to have a copy of the policy and the followup. He said he sent a followup letter, or was it just the policy you sent?

Mr. STONE. No. I sent a letter out, and we will be glad to give you a copy of it.

Mr. MITCHELL. I have no questions. I just want to congratulate you for moving in the right direction. Sometimes I am a little bit at odds with DOD, but not this morning.

Mr. STONE. Thank you, Mr. Chairman. It is an unaccustomed pleasure to be congratulated.

Mr. DAUB. I, too, share those same feelings, Mr. Chairman. Let me ask you a couple of questions.

Are you convinced that the bonding requirements are more than adequate to safeguard the Government's interest in every contract that is let without retainage?

Mr. STONE. Yes, I am convinced that the bonding requirements are adequate. Somebody criticized retainage earlier as being "doubly safe." There is nothing wrong with being doubly safe. We try to be very safe with the money we spend, but we think that judicious attention by our construction people—and we think they are very good people—can make up for what they lose by doing away with retainage.

Mr. **Daub**. Mr. Chairman, would it be inappropriate if I asked for this committee to be advised not in necessarily an absolutely formal way, but in a year from now with respect to just a summary of cost savings, paperwork savings, you know, after monitoring, keeping accounts, adding up all the money and figuring out the averages and all the things that are involved in retainage, how many contracts used to be, how much discretion was applied, how many ended up being for good reason underneath a retainage factor of some kind. At least, just a summary, just kind of a report, just to indicate a year from now that it is a policy that has had merit and has proved useful, whether or not it shows total dollar savings or not. Is there some way I could frame that so you could do that for us?

Mr. **Stone**. We will be glad to give you a report a year from now, Mr. Daub. I expect that we won't be able to tell you how much money we have saved or at least we won't be able to give you any numbers that would be worth believing, but we will give you a report.

Mr. **Mitchell**. Would the gentleman yield?

Mr. **Daub**. I would yield to the Chairman.

Mr. **Mitchell**. I think that is an excellent recommendation and you anticipated me just a little bit and that is great, but I would just suggest that let's look at it in 6 months. It went into effect in February. Certainly, within 6 months you will know about implementation, whether it is being done properly. You should have some pretty good clues. Maybe in 6 months and then in 1 year.

Mr. **Daub**. That would be fine, if you would, and it doesn't have to be, you know, 15 pages thick. It can be a 2- or 3-page summary just of your chiefs report to you of what they feel is happening with the new policy, and I do commend you for the implementation of that policy.

In your experience have you seen subcontractors come to you and say we are just not going to bid any more because of this? Did you pick that up from the people you deal with?

Mr. **Stone**. I haven't had much dealings with subcontractors, except through the American Subcontractors Association. I haven't heard that. Let me ask Colonel Glogal. Do you have in your experience subcontractors who don't want to bid on military contracts?

Colonel **Glogal**. Mr. Daub, we haven't that information direct from individual subcontractors. By that I mean subcontractors coming into our office and advising us that they would not bid. We have met with the national subcontracting associations and during those meetings we have been told that one of the reasons they don't do business with us is the prior retainage policy.

Mr. **Daub**. I have no more questions. Thank you, Mr. Chairman.

Mr. **Mitchell**. Mr. Hiler.

Mr. **Hiler**. Thank you, Mr. Chairman.

Mr. Stone, would you interpret the legislation as proposed to be stronger than the policy you have implemented?

Mr. **Stone**. The policy we have implemented, Mr. Hiler, is permissive and we are telling our construction agents, mainly the Army Corps of Engineers and the Navy Facilities Engineering

Command, that they can use retainage where they have a good reason to. I think the legislation is more restrictive than that.

Mr. HILER. Do you think that there should be some element of permissiveness in the legislation, or do you think it should be hard and fast?

Mr. STONE. I am afraid I am not knowledgeable enough about writing regulatory type legislation to advise you on that, Mr. Hiler. I just don't know.

Mr. HILER. Let me ask the question a different way then. If someone has a good reason for having retainage—and I think the reasons that you gave were if you had had problems on a previous contract or something of that sort—retainage could still be applied. Now, if you have a situation like that and if we pass a law that says no retainage is allowed, will you run into problems in dealing with problem contractors?

Mr. STONE. We would lose a club that we have to get work done quickly. It is a very powerful incentive to say that we will pay you the money we owe you if you finish the job. We will lose that club. I would expect that we would be able to survive, but it would make our job harder.

Mr. HILER. No further questions, Mr. Chairman.

Mr. MITCHELL. Thank you very much. I hope you have a full recovery very quickly.

Mr. STONE. Thank you, Mr. Chairman. I appreciate your consideration.

Mr. MITCHELL. Our next panel is comprised of Mr. Mark A. Gallagher, president of the Standard Mechanical Contractors, Inc., Mr. Thomas Furey, member of the Sheet Metal & Air Conditioning Contractors' National Association Inc., Mr. Al Harrell, president, HiLo Industries, and Mr. William Richie of Richie Electric Co.

Gentlemen, thank you for being here. I think we have copies of your testimony. I would suggest that if you so desire that you extract from your testimony the salient points. Your entire statement will appear in the record. If, however, you wish to present your statement in its entirety, that is up to you.

Why don't we start by recognizing Mr. Daub first?

Mr. DAUB. Thank you, Mr. Chairman. It is my pleasure to introduce to the committee a fellow Omahan, Tom Furey, president of Furey Heating and Air Conditioning. Mr. Furey is the type of individual we on this committee should be most interested in, but rarely have an opportunity to hear from.

Twenty-two years ago he began his own business from his home, from scratch, and has subsequently built a thriving business that employs almost 30 people. At the same time he has unselfishly given his time to the betterment of his profession. Twice he has been president of the Omaha Heating & Air Conditioning Contractors and is currently a member of the board of directors of the Sheet Metal & Air Conditioning Contractors National Association.

Mr. Chairman, I want to commend you for introducing this badly needed legislation in the form of H.R. 5022 and I am proud to be a cosponsor. Your personal prestige and the respect of your colleagues will do much to facilitate its speedy consideration. The testimony of Mr. Furey will give us on this committee a valuable insight into the problem from the perspective of small business and I look forward to it eagerly.

I want to point out as well that should jurisdiction be assigned on this bill to the Government Operations Committee, Government Activities and Transportation Subcommittee, I am pleased to report I sit on that subcommittee as well.

Mr. **Hiler**. Would the chairman yield?

Mr. **Mitchell**. I would be delighted to recognize the gentleman.

Mr. **Hiler**. Thank you, Mr. Chairman. I would also like to recognize Mark Gallagher here from South Bend. I would like to tell you that when I left this morning the weather was tremendous and it is going to be a nice day out there, but it looks like it is going to be a nice day here as well.

I, too, as Mr. Daub mentioned, am happy that we can have the firsthand testimony from all these gentlemen and particularly Mark from South Bend. It helps so much to our work on this subcommittee and, certainly, in the full committee when we can get some background as to how particular legislation will affect people that we know and businesses that we are aware of in our district.

I am hopeful that the outgrowth of this hearing will be a favorable bill passed and it will move to the Government Operations Committee, where I also sit. Hopefully, Mr. Daub and I will be sure that the facts are presented to that committee. Thank you.

Mr. **Mitchell**. Thank you, gentlemen. This is one of my better days when I know that we have a few stalwarts on that subcommittee, we can almost guarantee the passage of this legislation.

Mr. **Daub**. Mr. Chairman, there is a member of that committee that I hope you will counsel with.

Mr. **Mitchell**. Yes. Mr. Gallagher, why don't we hear from you first.

PANEL CONSISTING OF MARK A. GALLAGHER, THOMAS P. FUREY, ALFRED C. HARRELL, AND WILLIAM RICHIE

TESTIMONY OF MARK A. GALLAGHER, PRESIDENT, STANDARD MECHANICAL CONTRACTOR, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF PLUMBING-HEATING-COOLING CONTRACTORS

Mr. **Gallagher**. Thank you, Mr. Chairman.

This is my first time here. I might be a little nervous.

Mr. **Mitchell**. There is absolutely no reason to be.

Mr. **Gallagher**. I will continue on here and give my testimony.

My name is Mark A. Gallagher. I am a P.E., which is a registered professional engineer in the State of Indiana and I am president of my company called Standard Mechanical Contractor, Inc. of South Bend. Also, accompanying me today is my wife, who is the secretary of the corporation. We are a small business and we perform work in the plumbing, heating, ventilating, and air-conditioning work, including sheet metal and some limited site work, both in residential, commercial, and industrial type work.

We gross approximately $1.1 to $1.2 million a year. In addition, I am a member of the National Association of Plumbing-Heating-Cooling Contractors, our local St. Joe Valley and also our State affiliate.

Our National Association of Plumbing-Heating-Cooling Contractors is one of the oldest national associations in the construction industry. It has over 6,400 members. Its membership comes from every State in the Union. We have 300 State and local affiliated associations. This industry of ours employs over 400,000 people and has receipts of over $21 billion.

It is important to note about NAPHCC because I have been a member for approximately 13 years and it consists of many small businesses and enterprises. Therefore, our interests are in the communities and in our States and also in our country.

I am here today in support of eliminating retainage. It is for federally funded construction work, but I am also in favor of it being passed down to the normal everyday private construction-type work.

As it has been mentioned here, most contractors are required to put up performance bonds to insure completion of the contract. This cost is passed on to the end user usually and it is included in the contract price. It usually runs approximately 1 percent of the construction work.

However, despite this requirement of a performance bond, we also are required to have normally a 10-percent retainage requirement, which we are here about today. Meanwhile, I know that I have experienced a restricted cash flow while this retainage is withheld, which goes the total length of the project, I still have to pay for materials, cover payroll for labor, and meet everyday expenses, overhead and such, lights, heat, telephones, et cetera.

However, when working with a general contractor, we usually don't receive payment until he receives payment. So, this withheld retainage restricts our growth. It definitely restricts our cash flow and with retainage and performance bonds required, it is definitely a duplicate layer of protection.

I would just like to cite a particular project that we just completed the work on. We haven't got paid the retainage yet, and it is on the Beacon Heights low-income housing project in South Bend, Ind. We were the successful bidder back in 1980. The contract was for $386,000. It was a rehabilitation of existing apartment units: 150 existing and 24 new units.

Mr. **Mitchell.** Excuse me. When was that in 1980, what month?

Mr. **Gallagher.** I would have to think here a little bit. I think around October or prior to October, because we started site work in October 1980.

This work was performed under a general contractor. It was a HUD-insured contract. Therefore, they authorized and they controlled the payments. Again, we submitted invoices as we progressively worked on the job and 10 percent was withheld. Back on February 11, after we completed the job on April 6 was the exact date that we finally completed 100 percent of our work, and I wrote a couple of letters to the general contractor requesting that our retainage be reduced because I had heard that once a HUD job is roughly 90 percent complete, we can ask for at least half reduction, or half of the retainage, to 5 percent. They did finally, through a lot of effort, reduce it 2½ percent. So, we are still waiting for the other 7½ percent.

This $8,000 that we received was very welcomed, even though we would have preferred to have the complete retainage once our job was 100-percent complete. But let me just take you through a few steps that I have yet to experience. Number one, substantial completion, which has just been done last week, I understand. That is fact now.

We also have this thing called cost certification. That involves accountants and a number of other things and it normally takes a period of 60 days for that. After that is completed, then the closing can be done on the project and, hopefully, then payment to the general contractor and then followthrough from the general contractor down to us, to pay us.

We would anticipate—which upsets me in the sense that I know that I am at the bank borrowing money at 18 percent today—sometime at the end of July, we should hopefully receive our final payment.

On other jobs, I have experienced retainages as high as $86,000, as I recall in this particular case. We just completed a school job and that retainage was paid. I might add, retainage on school work back home, that money is put into an escrow agreement, not that it is a reason for not eliminating retainage, but at least being put into an escrow agreement between the school corporation and myself, we collect the interest on that money that is being held in escrow.

I just might go on here a little further that I just last Monday had to borrow $8,000 just to meet accounts payable and here I am borrowing at 18 percent from the bank and yet, there is well over or approximately $30,000 that is due me in withheld retainage.

Last year our company paid over $12,000 in interest rates or in interest and during this time, I am sorry to say, our company experienced a $3,700 loss for that same year. That was based on a gross sales of $1,067,000. This interest expense which is $12,000, I divided it into the man hours that we worked that particular year. It cost us 54 cents a man-hour for interest in order for our corporation to operate.

Why should retainage be eliminated? As far as I am concerned retainage should be eliminated because it would lower construction costs. It would definitely lessen borrowing requirements and also then the savings could be passed on to the owner with lower competitive bids. I just want to state that I know for a fact that what small margins we work on, it does erode what small margins of profit that we might have in our jobs, just due to the fact that people tend to use the retainage as a lever in the sense that everybody likes to work on everybody else's money for nothing.

Anyhow, Mr. Chairman, at this time I, as a small business contractor, support the Congress to eliminate this retainage withheld on Federal work and I would hope that you would be successful in doing such. With the help of my local association and my national and my State association, I appreciate this opportunity here to testify before you and if you have any questions, I would be happy to answer them.

Thank you very much.

[Mr. Gallagher's prepared statement and attachments follow:]

Prepared Statement of Mark A. Gallagher, President, Standard Mechanical Contractor, Inc., on Behalf of the National Association of Plumbing-Heating-Cooling Contractors

Mr. Chairman, my name is Mark A. Gallagher, P.E. and I am president of Standard Mechanical Contractor, Inc. of South Bend, Ind. We are a small business construction industry contractor and perform residential, commercial, and industrial work. We gross approximately $1.1 to $1.2 million a year. In addition, I am a member of the National Association of Plumbing-Heating-Cooling Contractors (NAPHCC), the Indiana PHCC and our local area PHCC of St. Joseph Valley.

The National Association of Plumbing-Heating-Cooling Contractors is the oldest national association in the construction industry and the largest in the plumbing-heating-cooling industry. It has over 6,400 members. Membership comes from every State in the country and is organized through about 300 State and local affiliated associations. This industry employs over 400,000 people and has receipts of over $21 billion.

It is important to note that the members of NAPHCC are small businesses and enterprises in the purest sense of the word. Contractors are locally based in the cities and towns throughout the country. Therefore our interests are in our communities and in our States and in our country.

I am appearing here today to support the elimination of retainage on Federal construction work.

Contractors are required to put up a performance bond to insure completion of the contract. This is a cost which we pass on in our bid on a contract. It usually runs approximately 1 percent of the construction work.

However, despite the performance bond, my company has up to 10 percent of the payments to which we are entitled held hostage. Meanwhile, we have bought materials, paid for labor, and covered for overhead during the construction period. When we complete our contract, we should receive full payment for our work.

However, as a subcontractor, we must continue to wait for payment until the general contractor has received his final payment which enables him to pay us. The result is that withholding retainage severely restricts our cash flow, restricts our ability to compete on other contracts, and results in an unnecessary and costly duplicate layer of protection.

Let me cite a current example of how this outmoded and unfair practice works.

BEACON HEIGHTS LOW INCOME HOUSING PROJECT

In 1980, my firm was the successful bidder for subcontract work on the Beacon Heights HUD low-income housing project in South Bend, Ind. Our $386,000 contract called for rehabilitation of the plumbing, heating, and sheet metal work and the site utility work for 174 housing units.

The project was performed under contract with the general contractor, Gibbons-Grable Co. through the assistance of a mortgage company. HUD was insuring the money, and therefore authorizing release of payments. My company began work in October 1980. As we completed work, we submitted the necessary documentation to receive progress payments. As is the practice when retainage is withheld, only 90 percent of each progress payment was received. The other 10 percent was retained.

By the beginning of this year, my company had completed 90 percent of the work. Frequently, when a substantial portion of the contract work is complete, the level of retainage is reduced. Therefore, at the suggestion of the HUD office in Indianapolis, I wrote the general contractor on February 11 asking that retainage be reduced to 5 percent. (Attachment A.) In my letter, I noted the trying economic conditions and the high interest rates which erode the small margin of profit which our company is entitled to make. Receiving no response, I followed up with another letter in March, one month later. (Attachment B.)

On April 6, I completed all work contracted for and therefore should have been entitled to the full $386,000 contract price. However, because of the retainage withheld, we were still waiting for the $38,600 withheld.

In response to my letter, retainage was reduced to 7½ percent in mid-April when I received a payment of approximately $8,000. It is my understanding that the remainder, approximately $30,000, will be paid after cost certification. Thus, we are still waiting for payment.

But Mr. Chairman, let's look at the steps and timing which must occur before we can expect payment.

(1) Substantial completion—HUD must make a determination that there has been substantial completion of all work by the general contractor. I understand that HUD was making that determination last week.

(2) Cost certification—It will take 60 days for cost certification to occur, approximately the end of June.

(3) Closing—Closing can occur anytime after cost certification has been completed.

(4) Payment to the general contractor—following closing, the general contractor will receive final payment including all sums withheld.

(5) Payment to the subcontractor—the general contractor will make final payment to my company of the retainage. I expect that it will take about 30 days to receive our money or about the end of July.

Thus, since October 1980 and with each successive progress payment over the 1½-year project, funds have been retained from our operations for completed work. This has accumulated to thousands of dollars. While we have had to continue to pay the bills of our suppliers and meet our payroll, we have not received full payment for the work to do so. In fact, I still must wait at least 3 more months for payment. Not only do we suffer from the negative cash flow, but we can't even earn any interest on the funds retained. Likewise, I do not have access to retainage withheld on other contracts. Thus, we have $50,000 owed to us in outstanding retainage.

Meanwhile, to keep other contracts going, we have had to go to our bank to draw on our line of credit. We have borrowed $45,000 at one point above prime (approximately 17⅜ percent) just to continue work in progress. In fact, in the last few days, we have just borrowed $8,000 additional.

Obviously, the delay in payment and the loss of interest seriously plagues the efficient management of my contracting business. Last year, my company paid $12,017 in interest. During that same year, my company experienced a net loss of $3,726.

ADVERSE EFFECTS OF RETAINAGE

Retainage severely restricts the cash flow of small businesses that can ill afford the added drain on our resources in this economy. Elimination of retainage will free up that cash flow, reduce borrowing requirements, especially at current high interest rates, and stimulate the economy.

The elimination of retainage will free up funds for operating capital for expansion, for seeking new contract opportunities and for producing new jobs. If retainage were eliminated, my company would be more likely to bid more jobs.

If retainage were eliminated, the cost of construction would be lowered. Contractors, such as my firm, would not be borrowing to make up for outstanding retainage. This savings in the cost of borrowing would be passed on to the Federal Government through lower competitive bids. This is the reverse of the current situation in which contractors must increase their cost of bids to cover the costs of the duplicate layer of protection of both retainage and the performance bond.

CONCLUSION

Mr. Chairman, as a small business contractor I urge the Congress to eliminate retainage. The practice of retainage unfairly and unnecessarily withdraws scarce cash flow from contractors. Instead, bonding should be used as the single, best source of protection.

Furthermore, any legislation to eliminate retainage should provide that the elimination applies to prime and subcontractors equally. Full payments for completed work should flow down to the subcontractors. Attached to my statement is the NAPHCC position on retainage (Attachment C).

Thank you for the opportunity to testify and I would be happy to answer any questions.

ATTACHMENT A

STANDARD MECHANICAL CONTRACTOR, INC.,
South Bend, Ind., February 11, 1982.

Re. Beacon Heights project, South Bend, Ind.

Mr. GERALD P. GULLING,
The Gibbons-Grable Co.,
Canton, Ohio.

DEAR MR. GULLING: After talking with the HUD office in Indianapolis, Indiana, they suggested that we submit in writing that our work on the above referenced project have the ten (10%) percent retaining reduced to five (5%) percent since the PLUMBING, HEATING and VENTILATION WORK is more than ninety (90%) percent complete.

I am requesting this reduction in retainage since the economic factors in our community including work for our company is extremely slow. As you know interest rates are very high and borrowed money for this project erodes the small margin that our company is entitled to make.

Under the circumstances HUD should consider this retainage reduction in order to ease our financial obligations and do same before cost certification is complete. Since our work is almost 100 percent complete it seems very unfair and will be extremely difficult for our company to wait till May or June before final payment is made without this retainage reduction.

Your earliest request to HUD on the above matter would be greatly appreciated.

Respectfully yours,

MARK A. GALLAGHER, P.E., *President.*

ATTACHMENT B

STANDARD MECHANICAL CONTRACTOR, INC.,
South Bend, Ind., March 10, 1982.

Re. Beacon Heights Project, South Bend, Ind.

Mr. GERALD P. GULLING,
The Gibbons-Grable Co.,
Canton, Ohio.

DEAR JERRY: One month ago I wrote you a letter about reducing the retainage on the above referenced project. As of the above date, I have not had a response from you or Mr. Waldron. Please inform the undersigned what response you have received from HUD, if any, and what other steps may be taken to show HUD that this retainage reduction is in order. Due to the extreme economic condition in our area we badly need reduction to ease our financial obligations.

Your earliest response to the above matter would be greatly appreciated.

Respectfully yours,

MARK A. GALLAGHER, P.E., *President.*

ATTACHMENT C

POSITION PAPER—ELIMINATION OF RETAINAGE

Retainage is the process under which a procuring agency will hold back part of the payment for work that has been completed as an incentive for a contractor to complete the job.

Elimination of retainages is an area that promises tremendous savings to the government. Traditionally, a certain percentage of payments are retained until construction is complete. This is to insure completion of the work. Naturally, the contractor factors this loss of use of funds into his bid. However, the contractor must also factor in the cost of his performance bond which insures completion of the work. Thus, by requiring both retainages and a performance bond, the government is paying for an unnecessary double layer of protection.

However, there is a significant body of opinion that believes both retainage and a performance bond are needed. Where retainage is held, the amount should be kept to a minimum. Contractors are obliged to pay higher interest rates on funds borrowed for working capital to offset retentions, thereby increasing construction costs. Therefore, retained funds, which have been earned by the contractor, should be placed in an interest bearing escrow account for payment to the contractor. Likewise, contractors should receive interest on late payments for all construction work completed.

RESOLVED

The National Association of Plumbing-Heating-Cooling Contractors supports Elimination of Retainage. Bonding should be used as the single, best source of protection. This should apply to prime and subcontractor equally, but where a company is unable to obtain bonding, retainage may be used as an alternative.

Where there are no bonding requirements, the percentage retained should be as low as possible, in no case more than 5 percent, until 50 percent of the work is completed, and then dropped.

The percentage level of any retention should be the same for subcontractors as for prime contractors on a job.

Release of retained funds and final payment, as well as figuring the point of reduction of retainage, should be done on a line item basis . . . that is, each contractor or subcontractor's work considered as a separate item.

Retained funds should be held in an escrow account with interest accruing to the benefit of the party to whom the funds are due.

Interest should be paid on late payments for completed work.

Mr. MITCHELL. Mr. Furey, please.

TESTIMONY OF THOMAS P. FUREY, PRESIDENT, FUREY HEATING & AIR CONDITIONING, AND MEMBER, SHEET METAL & AIR CONDITIONING CONTRACTORS' NATIONAL ASSOCIATION, INC.

Mr. FUREY. Thank you, Mr. Chairman. I want to thank you and the members of this subcommittee for inviting me here to testify today, to testify on H.R. 5022. If passed, the bill would eliminate the practice of retention on Federal projects, provided certain qualifications are met by the contractor.

My name is Thomas P. Furey. I am president of Furey Heating & Air Conditioning, Omaha. I have been in the sheet metal industry for almost 30 years and have owned and operated my own business for the past 22 years. My business consists primarily of fabrication and installation of architectural sheet metal, industrial and commercial, as well as fabricating and installing the heating and air conditioning and ventilating systems in the buildings.

I am also a member of the Sheet Metal & Air Conditioning Contractors' National Association, a national trade association representing some 2,700 sheet metal contractors involved in the various applications of the sheet metal trade. Currently, I serve on the board of directors for the national association.

By the standards of the Small Business Administration, I am classified as a small businessman. On the average I employ no more than 20 people and do an annual dollar volume of approximately $2 million. Of the contracts I perform annually, about 80 percent are private and 20 percent are public.

As you know, Mr. Chairman, during the last year and a half, the construction industry has suffered a serious downturn and my business has suffered along with it. In fact, since the first of the year I have had no new starts and my backlog continues to fall off.

Unfortunately, there appears to be little relief in the near future. The legislation you are considering today could help make a significant impact in relieving the economic pinch that many of us as small contractors are experiencing. We have already heard testimony here this morning that retention is redundant, inhibits cash flow and is inflationary. I will talk a little bit more about that as we go on.

What I particularly want to impress upon you this morning is that while this legislation is a step in the right direction, it falls painfully short of being effective in two very critical areas. It applies only to public contracts and there is no provision to require a flow down of retention payments between prime contractors and subcontractors. This second point is the most important. In fact, to my way of thinking, this entire process is shortsighted unless such flow down provision is included in the bill.

The practice of retention is damaging to contractors for several reasons, but perhaps the greatest problem created by retention is the stress that it places on a contractor's cash flow. We are talking about the operating capital that I must have to run my business. Because of retention thousands of dollars remain tied up for months and sometimes years before I ever have the opportunity to put it back into my business.

The common practice in both public and private contracts is to withhold all retained money until the owner takes possession of his property from the general contractor. These subcontractors who are involved in the early stages of a construction project end up waiting an unreasonable amount of time before they can receive their final payments. In the meantime costs for materials, supplies and labor excel at a price that exceeds my margin of profit. Let me explain what I mean by using an example.

Much of the work I perform is called architectural sheet metal. That is, it is the kind of construction that is performed very early on in the contract. Therefore, my working capital is tied up very early. If I have a contract of $100,000, the prime contractor will generally hold back 10 percent of each payment until the entire job, not just my portion, is completed. So, I end up completing 100 percent of my segment of the contract, but receive only 90 percent of the agreed upon price for such work. Remember that construction is a labor intensive industry. Therefore, the majority of my costs are eaten up in labor which must be paid out weekly. Considering the fact that 10 percent of the money will be locked up in retention, and I would like to stray a little bit from my written report this morning and roll this off the cuff a little bit, I think.

According to our national survey for 1981, our margin of profit is running 2 to 5 percent. Probably, we would have to go back to 1968 to when we were able to enjoy a 10-percent margin of profit. Since then, we, as well as anybody else, helped to whittle it down. So, what we have at this point is a very large portion of people think that 10-percent retainage is profit. It is really not. Maybe on a $100,000 job, $2,000 to $5,000 of it is your profit. The rest of it is sitting there in operating capital.

Go back and speak on an early end type of work. We sit down to bid a job. We have to take into consideration that somebody is going to be using our money or we are going to be using somebody else's money to supplement our operating capital. So, we could be in our other job, say, within the first 3 months and the general contractor has a 13-month completion date on the contract. Now, I as a businessman can be smart enough to know that I am going to have to be paying money on that money, interest on that money, that I have had to get at the bank in place of the capital and the amount of interest grows with the time you are moving in on a job to your final completion and this total moneys then, retainages, is sitting somewhere doing nothing, but costing other people a lot of money.

When a contractor knows that high retention will be withheld on a job, he will include his additional costs in the quotes on contract bids. Retainage thus encourages the practice of what is called front-end loading, which is—you have got to get your cost of your bond, which this bill would eliminate it right there in your job costs, which are dropping at that point because from there on I am not loading the interest that I am going to have to borrow to get me through the job.

To my way of thinking, I have some following recommendations that I would like to pass on. Retainage legislation would be expanded to cover private as well as public contracts. There is no legal requirement for prime contractors to withhold retainage from subcontractors. Yet, it is a common practice whose useful purpose has long since expired. There is absolutely no need for private retention because virtually every private contract requires the purchase of a performance bond. When performance bonds are furnished, the owner has recourse to the bonding company in the event that the contractor does not complete his contractual obligations. Thus, the owner does not need the retention to insure performance.

The same is true for the general contractor who has performance and payment bonds of subcontractors. If there is a qualified bond on the job, there is absolutely no justification for retention percentages of any amount. If I, as a subcontractor, thought I would be paid progress payments without the 10-percent retention being withheld, many contracts, both private and public, would be more attractive and I would be more likely to bid them. It is also likely that my bid prices would be lower. Ultimately, this is passed along as a savings to the owner and the user.

An additional reason for endorsing the use of performance bonds rather than retention is that bonds provide a way of policing or cleaning up the industry. What I am saying is that the contractor who can secure a performance bond is more likely to be a reputable business person than one who is not able to do so. Therefore, performance bonds provide a degree of protection from fly-by-night, flim-flam operations that give the construction industry a bad name.

Finally, and most importantly, this legislation is practically meaningless to me and others in my industry if it does not include some kind of language to allow subcontractors to enjoy the economic benefits which would come from the elimination of retention requirements. The only way to obtain these benefits is through a flow down provision.

As I read it, this legislation does not address retention of payments between prime contractors and subcontractors. I also understand that some individuals have argued that Congress does not have the authority to legislate this issue because the Federal Government is not in a privity of contract relationship with subcontractors. However, based on information and legal advice I have received from my national association, I believe that any such arguments are flawed in several respects.

Rather than go into the full legal explanation which was given to me, I have attached for the record a memorandum from our attorneys outlining the legal justifications and language which would allow Congress to include a flow-down provision in the legislation.

I might add, Mr. Chairman, that though the association which represents me and so many other sheet metal contractors is receptive to this legislation, it also will preface its most vigorous support on whether or not a flow-down provision is included. I know that they stand ready to work with you on language that would accomplish this goal.

In conclusion, Mr. Chairman, let me summarize my statement with regard to H.R. 5022:

Retention inflates the cost of contracts by forcing a contractor to front end load a job bid.

Performance bonds are much more preferable than retention as a method of guaranteeing satisfactory and timely job completion.

Elimination of retention should be extended to the private, as well as the public sector.

Legislation to eliminate retention is shortsighted without the inclusion of a flow-down provision to address retention of payments between prime contractors and subcontractors.

Finally, Mr. Chairman, I thank you and the members of this subcommittee for inviting me to testify before you here today. I applaud your efforts to bring this often overlooked situation to the attention of your colleagues in the House. Hopefully, we can work together to bring about some remedy to this problem.

I would be pleased to answer any questions you may have at this time.

[Mr. Furey's prepared statement and attachment follow:]

Prepared Statement of Thomas P. Furey, President, Furey Heating & Air Conditioning, and Member, Sheet Metal & Air Conditioning Contractors' National Association, Inc.

Good morning Mr. Chairman. I thank you and the members of this subcommittee for inviting me here today to testify before you on H.R. 5022, the "Small Business Contract Payment Procedures Act." If passed, this bill would eliminate the practice of retention on federal projects, provided certain qualifications are met by the contractor.

My name is Thomas P. Furey. I am President of Furey Heating and Air Conditioning, Inc. located in Omaha, Nebraska. I have been in the sheet metal and air conditioning industry for over 30 years and have owned my own business for the past 22 years. My business consists primarily of fabrication and installation of architectural sheet metal in large industrial and commercial buildings, as well as fabricating and installing the heating, air conditioning and ventilating systems in these buildings.

I am also a member of the Sheet Metal and Air Conditioning Contractors' National Association, Inc. (SMACNA) a national trade association representing some 2,700 sheet metal contractors involved in the various applications of the sheet metal trade. Currently, I serve on the Board of Directors for this national association.

By the standards of the Small Business Administration, I am classified as a small businessman. On the average I employ no more than 20 people and do an annual dollar volume of approximately $2 million. Of the contracts I perform annually about 80% are private and 20% are public. As you know, Mr. Chairman, during the last year and a half, the construction industry has suffered a serious downturn and my business has suffered along with it. In fact, since the first of the year I have had no new starts and my backlog continues to fall off. Unfortunately, there appears to be

LITTLE RELIEF AHEAD FOR US IN THE NEAR FUTURE.

THE LEGISLATION YOU ARE CONSIDERING TODAY COULD HELP MAKE A SIGNIFICANT IMPACT IN RELIEVING THE ECONOMIC PINCH THAT MANY OF US, AS SMALL CONTRACTORS, ARE EXPERIENCING. WE HAVE ALREADY HEARD IN TESTIMONY HERE THIS MORNING, THAT RETENTION IS REDUNDANT, INHIBITS CASH FLOW, AND IS INFLATIONARY. I'LL TALK A LITTLE BIT MORE ABOUT THAT AS WE GO ON.

WHAT I PARTICULARLY WANT TO IMPRESS UPON YOU THIS MORNING IS THAT WHILE THIS LEGISLATION IS A STEP IN THE RIGHT DIRECTION, IT FALLS PAINFULLY SHORT OF BEING EFFECTIVE IN TWO VERY CRITICAL AREAS: (1) IT APPLIES ONLY TO PUBLIC CONTRACTS, AND (2) THERE IS NO PROVISION TO REQUIRE A "FLOW-DOWN" OF RETENTION PAYMENTS BETWEEN PRIME CONTRACTORS AND SUBCONTRACTORS. THIS SECOND POINT IS MOST IMPORTANT. IN FACT, TO MY WAY OF THINKING THIS ENTIRE PROCESS IS SHORTSIGHTED UNLESS SUCH FLOW-DOWN PROVISION IS INCLUDED IN THE BILL.

CASH FLOW AND INFLATION

The practice of retention is damaging to contractors for several reasons. But perhaps the greatest problem created by retention is the stress that it places on a contractors' cash flow. Cash flow is the bottom line. We are talking about the operating capital it costs me to run my business. Because of retention thousands of dollars remain tied up for months and sometimes years before I ever have the opportunity to put it back into my business.

The common practice in both public and private contracts is to withhold all retained money until the owner takes possession of his property from the general contractor. Those subcontractors who are involved in the early stages of a construction project end up waiting an unreasonable amount of time before they can receive their final payments. In the meantime costs for materials, supplies and labor excel at a pace which exceeds my margin of profit on a previous job. Let me explain what I mean by using an example.

Much of the work I perform is called architectural sheet metal. That is, it is the kind of construction which is performed very early on in a contract, usually out-of-doors. Therefore, my working capital is tied up very early. If I have a contract of $100,000 the prime contractor will generally hold back 10% of each payment until the entire job - not just my portion - is completed. So, I end up completing 100% of my segment of the contract, but receive only 90% of the agreed upon price for such work. Remember that construction is a labor intensive industry. Therefore, the majority of my costs are eaten up in labor, supplies and materials. Considering the fact that 10% of my money is already

LOCKED UP IN RETENTION PAYMENTS, I AM LEFT WITH VERY LITTLE ROOM FOR PROFIT. IN FACT, BASED ON A 1981 STATISTICAL SURVEY CONDUCTED BY THE SHEET METAL AND AIR CONDITIONING CONTRACTORS' NATIONAL ASSOCIATION, INC., IT WAS SHOWN THAT THE AVERAGE SHEET METAL CONTRACTOR CAN EXPECT A PROFIT MARGIN OF NO MORE THAN 2% - 5% OF THE TOTAL COST OF ANY GIVEN CONTRACT. SO, ON A $100,000 CONTRACT I COULD EXPECT LITTLE MORE THAN $2,000 - $5,000 IN WORKING CAPITAL TO BEGIN NEW PROJECTS. THAT'S MY TOTAL PROFIT. YET THOUSANDS OF DOLLARS IN RETENTION PAYMENTS SIT IDLE IN THE HANDS OF SOME FEDERAL AGENCY OR PRIME CONTRACTOR.

WHAT CAN A SUBCONTRACTOR DO TO REPLACE THESE VALUABLE FUNDS? ACTUALLY THERE ARE SEVERAL CHOICES; NONE OF THEM DESIRABLE, ALL OF THEM INFLATIONARY. HE CAN BORROW THE MONEY FROM HIS OWN FUNDS, BUT SOONER OR LATER HE MUST RECOVER THESE FUNDS AS AN UNAVOIDABLE COST OF DOING BUSINESS. HE CAN GET A LOAN FROM THE BANK, BUT IN TODAY'S DOLLAR MARKET, HE MUST PAY AT LEAST 17.5% INTEREST. HE CAN FIND A WAY TO PASS IT ALONG TO A LOWER TIER SUBCONTRACTOR OR SUPPLIER. ULTIMATELY, HOWEVER, IT IS THE USER WHO BEARS THE BRUNT OF RETAINAGE COSTS.

FINALLY, WHEN A CONTRACTOR KNOWS THAT HIGH RETENTION WILL BE WITHHELD ON A JOB, HE IS LIKELY TO INCLUDE THESE ADDITIONAL COSTS IN THE QUOTES ON CONTRACT BIDS. RETAINAGE THUS ENCOURAGES THE PRACTICE OF WHAT IS CALLED "FRONT-END" LOADING. THAT IS, IN ORDER TO RELIEVE HIS TIGHT CASH POSITION HE WILL LOAD ON TO THE ACTUAL COSTS FOR LABOR AND MATERIALS TO RECOVER, IN THE INITIAL PHASES OF A JOB, SOME OF THE START-UP COSTS. FROM THIS EXAMPLE, IT IS EASY TO SEE HOW RETAINAGE FEEDS THE EVER-GROWING INFLATIONARY SPIRAL.

As I MENTIONED EARLIER THE LEGISLATION BEFORE YOU TODAY IS A STEP , AND JUST A STEP, IN THE RIGHT DIRECTION TOWARD REMEDYING THE PROBLEMS CREATED BY RETENTION. YET, TO MY WAY OF THINKING IT DOESN'T GO FAR ENOUGH, AND I OFFER THE FOLLOWING RECOMMENDATIONS TO IMPROVE IT.

EXPAND TO INCLUDE PRIVATE WORK

FIRST, RETAINAGE LEGISLATION SHOULD BE EXPANDED TO COVER PRIVATE AS WELL AS PUBLIC CONTRACTS. THERE IS NO LEGAL REQUIREMENT FOR PRIME CONTRACTORS TO WITHHOLD RETAINAGE FROM SUBCONTRACTORS. YET IT'S A COMMON PRACTICE WHOSE USEFUL PURPOSE HAS LONG SINCE EXPIRED. THERE IS ABSOLUTELY NO NEED FOR PRIVATE RETENTION BECAUSE VIRTUALLY EVERY PRIVATE CONTRACT REQUIRES THE PURCHASE OF A PERFORMANCE BOND. WHEN BONDS ARE FURNISHED, THE OWNER HAS RECOURSE TO THE BONDING COMPANY IN THE EVENT THAT THE CONTRACTOR DOES NOT COMPLETE HIS CONTRACTUAL OBLIGATIONS. THUS, THE OWNER DOES NOT NEED THE RETENTION TO INSURE PERFORMANCE. THE SAME IS TRUE FOR A GENERAL CONTRACTOR HAVING PERFORMANCE AND PAYMENT BONDS ON SUBCONTRACTORS. IF THERE IS A QUALIFIED BOND ON THE JOB, THERE IS ABSOLUTELY NO JUSTIFICATION FOR RETENTION PERCENTAGES OF ANY AMOUNT. IF I, AS A SUBCONTRACTOR, THOUGHT I WOULD BE PAID PROGRESS PAYMENTS WITHOUT 10% RETENTION BEING WITHHELD, MANY CONTRACTS - BOTH PUBLIC AND PRIVATE - WOULD BE MUCH MORE ATTRACTIVE AND I WOULD BE MORE LIKELY TO BID THEM. IT IS ALSO LIKELY THAT MY BID PRICES WOULD BE LOWER. ULTIMATELY, THIS IS PASSED ALONG AS A SAVINGS TO THE OWNER AND THE USER.

AN ADDITIONAL REASON FOR ENDORSING THE USE OF PERFORMANCE BONDS RATHER THAN RETENTION IS THAT BONDS PROVIDE A WAY OF POLICING OR CLEANING UP THE INDUSTRY. WHAT I AM SAYING IS THAT ANY

CONTRACTOR WHO CAN SECURE A PERFORMANCE BOND IS MORE LIKELY TO BE A REPUTABLE BUSINESSPERSON THAN ONE WHO IS NOT ABLE TO DO SO. THEREFORE, PERFORMANCE BONDS PROVIDE A DEGREE OF PROTECTION FROM FLY-BY-NIGHT, FLIM-FLAM OPERATIONS THAT GIVE THE CONSTRUCTION INDUSTRY A BAD NAME.

"FLOW-DOWN" PROVISION

FINALLY, AND MOST IMPORTANTLY, THIS LEGISLATION IS PRACTICALLY MEANINGLESS TO ME AND OTHERS IN MY INDUSTRY, IF IT DOES NOT INCLUDE SOME KIND OF LANGUAGE TO ALLOW SUBCONTRACTORS TO ENJOY THE ECONOMIC BENEFITS WHICH WOULD COME FROM THE ELIMINATION OF RETENTION REQUIREMENTS. THE ONLY WAY TO OBTAIN THESE BENEFITS IS THROUGH A "FLOW-DOWN" PROVISION. AS I READ IT, THIS LEGISLATION DOES NOT ADDRESS RETENTION OF PAYMENTS BETWEEN PRIME CONTRACTORS AND SUBCONTRACTORS. I ALSO UNDERSTAND THAT SOME INDIVIDUALS HAVE ARGUED THAT CONGRESS DOES NOT HAVE THE AUTHORITY TO LEGISLATE THIS ISSUE BECAUSE THE FEDERAL GOVERNMENT IS NOT IN A "PRIVITY OF CONTRACT" RELATIONSHIP WITH SUBCONTRACTORS. HOWEVER, BASED ON THE INFORMATION AND LEGAL ADVICE I HAVE RECEIVED FROM MY NATIONAL ASSOCIATION, I BELIEVE THAT ANY SUCH ARGUMENTS ARE FLAWED IN SEVERAL RESPECTS. RATHER THAN GO INTO THE FULL LEGAL EXPLANATION WHICH WAS GIVEN TO ME, I HAVE ATTACHED FOR THE RECORD A MEMORANDUM FROM OUR ATTORNEYS OUTLINING THE LEGAL JUSTIFICATIONS AND LANGUAGE WHICH WOULD ALLOW CONGRESS TO INCLUDE A "FLOW-DOWN" PROVISION IN THE LEGISLATION. I MIGHT ADD, MR. CHAIRMAN, THAT THOUGH THE ASSOCIATION WHICH REPRESENTS ME AND SO MANY OTHER SHEET METAL CONTRACTORS IS RECEPTIVE TO THIS LEGISLATION, IT ALSO WILL PREFACE ITS MOST VIGOROUS SUPPORT ON WHETHER OR NOT A FLOW-DOWN PROVISION IS INCLUDED. I KNOW THAT THEY STAND READY TO WORK WITH YOU ON LANGUAGE THAT WOULD ACCOMPLISH THAT GOAL.

MEMORANDUM

RE: Small Business Contract
Payment Procedures Act

Two bills - H.R. 5022 and S. 1782 - have recently been introduced in Congress concerning retention of progress payments on contracts between the federal government and its contractors. This legislation does not address retention of payments between contractors and subcontractors. Some individuals have argued, however, that Congress does not have the authority to legislate regarding this issue, because the federal government is not in privity of contract with subcontractors. This argument is flawed in several respects.

The only limitation on congressional power to legislate are those contained in the Constitution. Those individuals who argue that lack of privity deprives Congress of its authority to legislate, are really saying that the Constitution requires privity of contract for Congress to legislate.

First, even if privity of contract were constitutionally required, Congress would have the authority to legislate regarding retention of payments between contractors and subcontractors. Federal contractors are in privity of contract with the federal government. To regulate retention between contractors and subcontractors it is only necessary to regulate the contractors. Congress could enact legislation requiring contractors, as a condition of doing business with the federal government, to comply with certain laws and regulations regarding retention of payments to their subcontractors. This legislation would apply only to contractors who are in privity with the federal government, but it would effectively regulate contract retention between contractors and subcontractors.

Second, privity of contract is not constitutionally required. The Constitution does not -- either directly or indirectly -- make privity of contract a prerequisite for assertion of congressional authority. Congress has enacted thousands of laws regulating millions of individuals and businesses, the vast majority of whom are not in privity with the federal government. To give just a few examples, Congress has enacted the federal income tax, the Fair Labor Standards Act, which requires businesses to pay their employees the federal minimum wage; the National Labor Relations Act which regulates labor relations between employers and labor organizations; and the Davis-Bacon Act, which specifically provides that contractors and subcontractors performing construction work for the federal government have to pay their employees certain minimum wages. All of these laws apply with equal force to subcontractors who are not in privity with the federal government. Subcontractors pay federal income taxes, subcontractors are subject to the Fair Labor Standards Act; subcontractors are subject to the National Labor Relations Act; and subcontractors are explicitly subject to the Davis-Bacon Act. Lack of privity does not deprive Congress of its authority to legislate.

Beyond the question of privity, the Constitution does not restrict congressional authority to enact legislation regarding retention of payments between contractors and subcontractors. One could argue that such legislation would violate the Fifth Amendment, because it would deprive contractors and subcontractors of liberty and property "without due process of law." However, the Supreme Court has consistently held that when a legislature passes a law which affects a general class of persons - in this case, contractors and subcontractors - those persons have all received due process - the legislative process. Nowak, Rotunda, & Young, Constitutional Law, p. 500 (1978) (hereinafter cited as "Nowak"). See, for example, Bi-Metallic Investment Co. v. Colorado, 239 U.S. 441 (1915). In addition, one could argue that such legislation would impair the obligation of contracts between contractors and subcontractors, and hence would violate the Due Process Clause of the Fifth Amendment. This argument could be made only if the legislation applied to current contracts. Most likely the legislation would apply only to future contracts. However, even if it did apply to current contracts, the Supreme Court has displayed a willingness to uphold federal legislation impairing obligation of contracts so long as the legislation has a "rational relationship to a proper governmental end . . . even though it may impair recognizable property rights." Nowak, p. 433. Since insuring a stable construction industry is certainly a "proper governmental end," impairment of contract is not a justifiable constitutional objection to such legislation. Finally, one could argue that such legislation exceeds Congressional power under the Commerce Clause, because it regulates payment retention and not commerce. In response to that argument it should be recognized that since 1936 the Supreme Court has not invalidated any federal law requiring private parties because it exceeded the commerce power. See Tribe, American Constitutional Law, pp. 235-36. In short, the Constitution does not deprive Congress of its authority to legislate regarding payment retention between contractors and subcontractors.

In summary, Congress has full authority to regulate retention of progress payments between federal contractors and their subcontractors for these reasons:

1. Even if privity of contract were constitutionally required, the federal government could require contractors - who are in privity with the federal government - to comply with laws and regulations regarding retention of payments to their subcontractors.
2. Privity of contract is not constitutionally required.
3. Beyond the question of privity, there is no other justifiable basis for an assertion that legislation regarding retention of payments between contractors and subcontractors is beyond congressional authority.

FELHABER, LARSON, FENLON & VOGT, P.A.

Robert J. Fenlon

PROPOSED AMENDMENT TO S. 1782 AND H.R. 5022

"(e) Executive agencies shall require -

"(1) All parties receiving payments pursuant to subsections (d)(2) and (d)(3) to immediately pay their subcontractors in full without retention of any percentages of the contract price for all work performed by the subcontractors; and

"(2) All subcontractors receiving payments pursuant to subsection (e)(1) of this subsection to pay their subcontractors, if any, in full without retention of any percentage of the contract price for all work performed by the subcontractors."

CONCLUSION

In conclusion, Mr. Chairman, let me summarize my statement with regard to H.R. 5022.

- Retention inflates the cost of contracts by forcing a contractor to "front-end" load a job bid.
- Performance bonds are much more preferrable than retention as a method of guaranteeing satisfactory and timely job completion.
- Elimination of retention should be extended to the private, as well as public sector.
- Legislation to eliminate retention is shortsighted without the inclusion of a "flow-down" provision to address retention of payments between prime contractors and subcontractors.

Finally, Mr. Chairman, I thank you and the members of this subcommittee for inviting me to testify before you here today. I applaud your efforts to bring this often overlooked situation to the attention of your colleagues in the House. Hopefully, we can work together to bring about some remedy to this problem.

I would be pleased to answer any questions you may have at this time.

Mr. MITCHELL. Mr. Harrell, please.

TESTIMONY OF ALFRED C. HARRELL, PRESIDENT, HI LO INDUSTRIES, INC., AND MEMBER, NATIONAL ASSOCIATION OF MINORITY CONTRACTORS, ACCOMPANIED BY DEWEY THOMAS, EXECUTIVE DIRECTOR

Mr. HARRELL. Mr. Chairman, my name is Alfred C. Harrell, president of Hi Lo Industries, Inc. and a member of the National Association of Minority Contractors. I am accompanied by Mr. Dewey Thomas, executive director of NAMC.

On behalf of Hi Lo Industries, NAMC, and its national membership, we want to thank you for granting us this opportunity to testify on the issue of retainage and in support of H.R. 5022.

The National Association of Minority Contractors was incorporated in 1969 to assist blacks, women, Puerto Ricans, Mexican Americans, Native Americans, and Asian Americans within the construction industry. The membership of NAMC has grown to 30 States, the District of Columbia, and the Virgin Islands. The primary function of the association is to serve as an advocate for minority construction contractors.

Hi Lo Industries is a 5-year-old minority-owned firm located in Silver Spring, Md. We are construction specialty contractors involved in retrofit. During our past business year, we provided employment for over 50 skilled and unskilled persons and anticipate during the course of this business year employment for approximately 150 persons.

Mr. Chairman, I know that my fellow contractors will and have supplied this committee with enough statistical data that will support H.R. 5022. Therefore, I would like to take this opportunity to explain the additional financial hardships retainage has on minority construction contractors. I use the word "additional" because we do have the same business problems of other contractors. Because of the additional hardship the issue of retainage has on minority construction contractors, we are testifying in support of the complete elimination of all retainage requirements on federally funded projects.

Some of the additional hardships encountered by minority contractors where there is a retainage factor are insufficient working capital, supply and material costs, as well as overhead costs. This is based on a survey recently conducted by NAMC of some of its members.

Bonding: For every 22 minority construction contractors that apply for a payment/performance bond, 75 to 85 percent are declined.

Working capital: For every 10 minority construction contractors that request working capital from a bank, 8 out of the 10 are turned down.

Supply/material credit: For every 10 minority construction contractors that requests credit from their suppliers, 5 out of every 10 of these are turned down.

If you follow me in our written testimony, we will attempt to develop some classic examples of the cash effect that retainage requirements have on minority contractors. Part of a survey taken on a control group of NAMC members point out the following factors.

[Survey referred to above follows:]

CONTROL GROUP

[Annual sales ranging from $250,000 to $1,500,000]

Accounts receivable	Less than 90 days retentions	Retentions[1]
	(A)	(B)
$100,000	$10,000	$25,000
250,000	25,000	50,000
500,000	50,000	90,000
1,000,000	100,000	125,000
1,850,000	185,000	290,000

[1] Over 90 days to 18 mo.

* Columns (A) + (B) = $475,000.

If we could take this $475,000 in retentions and redistribute it back into the 20 companies this example represents, it would be the equivalent to $23,750 per company. The following positive assumptions could be made: (1) Improve the current cash position of each company; (2) Improve the bonding ability of each company; (3) Reduce accounts payable; (4) Reduce interest expenses; and (5) Improve the companies credit standard.

In addition, the contractors would improve their ability to determine their own destinies.

Mr. **Harrell**. I would like Mr. Dewey Thomas, executive director of NAMC to explain this control group factor to you.

Mr. **Thomas**. Mr. Chairman, what we did over the past year was to take 20 of our subcontractors and also a couple of GC's in relationship to retention and what effect did it really have on their company. As you see here, we took a gross sales range from $250,000 up to $1.5 million. Now, within this control group, their receivables fell in the first column.

The second column shows the standard 10 percent that was deducted under the retention clause. Now, the last column we feel is a very significant column because it shows that anywhere from 90 days to 18 months, this kind of money was tied up over and above the regular time period that they looked forward to collecting retentions.

We just did some little mathematics as you see here showing that if this $475,000 could be redistributed on a timely matter back into these 20 companies, it would be approximately $23,000. Now, this would do several things for these companies. No. 1, it would improve the cash position of each company.

No. 2, it would improve the bondability of each company, which is needed very badly. They could reduce their accounts payables, reduce interest expenses, and improve the companies' credit standard.

I would like to just go back for a minute to No. 4 because even though we put that in, I don't think that is a very true one. We are at this time virtually shut out of the market of short-term working capital for companies in the size range that we have pointed out and where the minority companies are currently financing this retention problem is from withholding taxes. They are not paying their withholding taxes. They are using this money that they have deducted and are supposed to be holding in escrow or in trust for the Federal Government to meet their expenses.

What I am saying here today is that if we could eliminate this retention problem, we in turn would eliminate 50 percent of all the problems that IRS is currently having with minority contractors of this size. I don't want to name the IRS agent, but I have talked to a couple of the IRS agents, and in each case the amount of money that is outstanding to IRS on a delinquent basis, and now with the increase they have put including the interest, which is around 20 percent now, plus the penalty, in each case the retention in these companies over 90 days exceeds the amount of money that they have outstanding to the Internal Revenue Service. So, I would like to just put that in, point that out that that is a fact and it is something that I feel that we should look at in considering H.R. 5022.

Mr. MITCHELL. Thank you.

Mr. HARRELL. Now, in addition to the elimination of retainages, the contractor, the minority contractor specifically, would improve their ability to determine their own destinies.

In our testimony today, I have tried to point out what additional financial hardships that the current practice of retainage has on minority construction contractors. I hope that our testimony has provided this committee with some additional insight and the effects this regressive practice of retainage imposes on minority construction contractors.

Again, I thank this committee for providing me and NAMC with the opportunity to address you and that we are available for future consultation and questions.

Mr. MITCHELL. Thank you, sir.

Mr. Richie, please.

TESTIMONY OF WILLIAM RICHIE, PRESIDENT, RICHIE ELECTRIC CO., SAN ANTONIO, TEX.

Mr. RICHIE. Mr. Chairman and members of the committee, my name is Bill Richie. I am an electrical contractor and my company is Richie Electric from San Antonio, Tex. I would like to thank you for the opportunity to appear here today and talk about the problems which stem from the process of withholding retainage on Federal construction.

Richie Electric is a small business. It is a family business founded about 35 years ago. We are a member of the National Electric Contractors Association. We do an average annual volume of about $2 million, and 80 percent of that is in Federal construction work, mostly with the Department of Defense.

I am here to state from personal experience that the practice of withholding funds from progress payments to contractors is a practice which should be eliminated. My personal experience suggests a number of reasons why retainage should be eliminated. Most of those have been previously spoken to. One, it costs the Government money; two, it limits the number of qualified contractors who may bid on a job; three, it puts an unnecessary and dangerous strain on the finances of the small contractor, and four, it adds no so-called protection for the Government.

Currently, Richie Electric Co. is involved in about 20 Federal contracts. The amount of money being withheld from those contracts in retainage is a little over $100,000 and that is exactly the amount of money that I have to finance with a note with my bank to keep my jobs going. That money is costing me, and indirectly the Government, because the interest rate is 16 to 18 percent.

As if that weren't bad enough, those retained funds don't come back to me after my work is completed and finally accepted. On every job, that final payment doesn't come until 6 to 9 months after a job has been closed out. In some cases the Government has had beneficial occupancy of the building for as long as 6 months before we get our final payments.

Now, when I bid a job, I have to figure into my bid the costs of borrowing this money. They are a significant factor in my overhead and can't be discounted. As a result the Government, my customer, is paying for these costs. Since these jobs are bid competitively, it is to the contractor's interest to make his bid as low as possible. You can be sure that any savings that I would realize in the elimination of retainages would be passed on in my bid prices.

In no other type of business is such a practice as withholding retainage acceptable. Manufacturers expect to be paid on time and in full. Contractors cannot withhold any part of payment due them. Our employees expect to be paid on time and in full. Only the contractor is expected to shoulder this burden of retainage.

Because I have to pay my materials suppliers and employees on time and in full, the difference between the amount due me and the amount actually paid must be financed. Today, with interest rates gone out of sight, it is more and more difficult to do this. Many small businesses may be unable to find the necessary financing. Even though they might be able to do a good job, they are effectively barred from bidding because of the practice of withholding retainage. For those that are able to find the necessary financing, it puts an extra financial strain on cash flow which may limit the abilitv to bid other work. This means that a retainage on one job may cause a cash flow strain to keep me from bidding other jobs. In effect the practice of withholding retainage is costing me business.

The supposed reason for retainage is for protection of the owner. This money held in reserve is supposed to help assure that a job is complete and done on time. Perhaps more than any other owner, the Federal Government is fully protected without the necessity of withholding percentages of the progress payments.

The Federal Government requires that a contractor post all kinds of protective sureties. The bid is guaranteed by a bid bond. The payments to employees and material suppliers are guaranteed by payment bond and, in addition, the whole contract is guaranteed by a performance bond. There is an additional factor that I noted hasn't been brought up here and that is the warranty.

We are required by the contract and the Federal Government to warranty our work for a period of 1 year. So, in addition to whatever may appear on the punchlist, we are responsible for that work for a period of 1 year. We have been in the contracting business in our area of Texas on Government installations for 35 years and our reputation with respect to warranty and punchlist is very important to us. It is my feeling and those of the contractors who are similar to me that the protections are totally there to insure that the Government gets all that it contracted to get without the need for retainage.

Additionally, my work must be inspected and approved before I receive any payment. I do not receive payment for work which, through my fault or somebody else's, is deemed to be faulty or not in accordance with the plans and specifications. The only work that I get paid for is the work that has been inspected and everyone agrees is properly installed and in good order.

Finally, it is my hope that the Congress will act as soon as possible to pass H.R. 5022. It will save the Government money. It will increase competition for jobs and will remove a heavy cash flow burden from small contractors, such as myself.

Mr. Chairman, I would like to thank you for introducing this important legislation and for allowing me this opportunity to express my support for it.

Mr. MITCHELL. Thank you, sir.

I have a few questions. First, Mr. Furey, it is more of a comment. You indicate that the legislation should address the private sector as well. I have some reservations about that. We heard from some witnesses who said if the Government policy is changed, more than likely the private sector would follow and it would seem to me that it would be better to use that approach of trying the Government first, and see whether or not these practices are ended.

Mr. Harrell and Mr. Thomas, I understand how businesses operate. Sometimes, you rob Peter to pay Paul. You said you make up for the retainage by slow payment on your income tax withholding. Don't you really compound your problem? Don't you pay an interest?

Mr. THOMAS. Oh, without a doubt. I am not making any judgment factor on it. Without a doubt, it does, but it comes down to a point of survival. We, because of the size of our association, perhaps get a little more involved in some of the businesses than some of my counterparts do. I would say over the last 2 months I have received several phone calls asking me to call IRS collectors or whatever you want to call them and get them off my back. As soon as I collect so and so I will pay them, but they just ride me.

My stock question when I am asked to do this is how much do you have tied up in retentions that exceed 90 days. How much do you owe the Federal Government? In each case it always exceeded the amount owed to the Federal Government in withholding. In other words, it is not a piece of advice that I give them to do that. It is a fact of life.

Mr. MITCHELL. But you are still increasing your cost because you pay interest for late payments on withholding.

Mr. Richie, the Department of Defense has announced—you were here when we heard about that—a policy change. You do about 80 percent of your work with the Federal Government. Is that correct?

Mr. RICHIE. That is correct, sir.

Mr. MITCHELL. Do you do any with the Department of Defense?

Mr. RICHIE. Yes; a great deal of work with the Department of Defense.

Mr. **Mitchell**. Was there any discussion between you and contracting officers about this new policy? Were you aware that it was in effect?

Mr. **Richie**. Yes, I am. I have contracts which represent three categories relative to retainage. I have the contract in which the retainage is a part of the contract documents and is as the Defense Department functioned previous to their February announcement where they withhold retainage.

I have one contract where I wasn't aware of the policy change and my general contractor does not have retainage withheld from his draws, but his subcontract with me has in its normal terms, the 10 percent. So, when I say that I complete $1,000 of electrical work, he bills the Government for $1,000 but only pays me $900. So, he has got at the present time $40,000 of my money tied up that he really has, that the Government is paying him.

Then I am also involved in one contract and starting up another one under the new policy where they announced at the preconstruction conference that as long as the project remains on schedule that there will be no retainage withheld and those are negotiated in my subcontracts, as well.

Mr. **Mitchell**. Mr. Daub.

Mr. **Daub**. Mr. Chairman, I think every question has been asked that I can think of. I really appreciate your testimony. I want to sympathize with the problem that some minority contractors may have, and that temptation to utilize their tax bracket and you might indicate that if they would go to that collector or that district office in the first place and advise of the problem, they will be in most cases—and remember there is somebody's Congressman around somewhere, too, that can help, to establish a rapport so that, in fact, they may not be subject to the penalties that occur and the padlocking that could occur.

This is a time in our economy when everybody ought to be cooperating. That is Government officials included, with the strains that occur. You give us a reason to look more carefully at what retainage does to cash flow. By the same token may I urge you to talk to those businesses that we want to see stay around for a long time to come, that there are other ways that they can avoid some of that extra cost, if they will just go in and say this is my problem and we are going to be in trouble on this and want to tell you now, don't want you harassing us or closing us down because of the problem and they usually can work it out. I did really want to point that out.

Beyond that, I want to thank each and every one of you for your testimony and you certainly helped me to understand the issue better and build a record to be able to talk with my colleagues about this important advantage for what I consider to be a small business issue and maybe one of the best ones we have undertaken so far in my first term in Congress, Mr. Chairman.

Thank you very much.

Mr. **Mitchell**. Mr. Hiler.

Mr. **Hiler**. Thank you, Mr. Chairman.

Mr. Gallagher, you had mentioned that with school construction in Indiana, money is put into an escrow account and interest is paid on that, which I presume you get the interest that is earned in that escrow account.

Mr. GALLAGHER. Yes.

Mr. HILER. In general, what do you think about that arrangement?

Mr. GALLAGHER. I personally would prefer the retainage not to be withheld, due to the fact that we do have to provide the performance bonds and a number of other guarantees, but it is better than somebody working on your money and not having it put into an escrow agreement. If I had my druthers, I would rather have it in an escrow account drawing interest on it because, in essence, I am at the bank drawing interest at 18 percent. But possibly on the other end, in the escrow agreement, depending on the escrow agent, its rate is some place around 12 percent and sometimes less than that, depending on the arrangements in the contract.

Mr. HILER. Mr. Chairman, I have no further questions and I, along with Mr. Daub's comments, appreciate the testimony we have received today.

I would like to make one comment on an issue that was brought up last week, however. I chatted with my SBA office in South Bend and I asked if they had gotten a mysterious phone call last week to send all their records to Washington concerning phone calls they had received. Yes, they had, and they were curious what that was all about. So, I advised them that they had given a birthday present to the chairman.

Mr. MITCHELL. Well, that is very nice, but there have been some subsequent very interesting developments based on other phone calls. We have called an SBA office and gotten a recording.

Gentlemen, thank you very, very much for your participation. We really appreciate it.

This hearing is now adjourned.

[Whereupon, at 12:17 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

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